CONSUMER PRICE INDEX

HEARINGS

BEFORE THE

SUBCOMMITTEE ON CONGRESSIONAL OPERATIONS AND OVERSIGHT

OF THE

COMMITTEE ON GOVERNMENTAL AFFAIRS UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

SECOND SESSION

APRIL 20 AND MAY 13, 1982

Printed for the use of the Committee on Governmental Affairs

U.S. GOVERNMENT PRINTING OFFICE
11-817 O
WASHINGTON : 1983

S401-24

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CONSUMER PRICE INDEX

TUESDAY, APRIL 20, 1982

U.S. SENATE,
SUBCOMMITTEE ON CONGRESSIONAL
OPERATIONS AND OVERSIGHT,
COMMITTEE ON GOVERNMENTAL AFFAIRS,
Washington, D.C.

The subcommittee met at 9:23 a.m., in room 3302, Dirksen Senate Office Building, Hon. Mack Mattingly (chairman of the subcommittee) presiding.

Present: Senators Mattingly and Glenn.

Senator MATTINGLY. This will be the first hearing of the Subcommittee on Congressional Operations and Oversight in reference to the Consumer Price Index.

Before we get under way this morning, Senator Glenn has a statement that he would like to make and I will let him do it at this time.

Senator GLENN. Thank you very much, Mr. Chairman. I do appreciate your courtesy in letting me make just a short statement this morning.

I would ask that a longer statement be included in the record.

Senator MATTINGLY. Without objection.

OPENING STATEMENT OF SENATOR GLENN

Senator GLENN. Even though the subject I want to bring up this morning is not the basic subject of your hearing, I did want to bring it up because I think it is so important, and that is the funding cut that you are facing, Ms. Norwood. That is something I think we have to look into very carefully here. If there is one thing we are dependent on, it is the statistics we get on which we base legislation. We are all aware of how important the Bureau of Labor Statistics is in the proper functioning of many Federal programs, indeed to even a basic understanding of our whole economic situation in the country with respect to unemployment. The payroll survey done by the Bureau is particularly important in times of economic stress, because it tells how many people have been laid off in various sectors, even when the gross employment statistics may indicate an increase in the total number of jobs.

The Consumer Price Index on which we base so many other things and so much judgment of what is going on in the country is one that has to be calculated just as accurately as we possibly can.

Last year, the Bureau, along with other agencies, took a 12-percent cut in the program funding for fiscal year 1982 and that involved elimination or severe curtailment in major program areas, a reduction close to some 200 people, as I understand it, out of your operations. I would like to submit for the record a list of programs which have been reduced or eliminated due to the 12-percent reduction.[1]

The additional cut that is now being proposed presents a severe funding problem for the Bureau that could threaten the accurate computation of our basic national indicators. The Agency is asking for a program supplement of $5.7 million and a $3.4 million pay supplement. I can't think of a better place where we should be putting that money to make sure we get accurate figures.

Some of the adverse actions that could follow failure to approve the supplemental would be: A portion of the current population survey would be suspended and all the quality control data collection would be suspended; the survey activities undertaken to maintain the accuracy of the CPI outlet sample could be suspended; some actual data collection would be suspended in all price programs and contracts with State agencies in the Bureau of Labor Statistics payroll would be reduced markedly. This would affect the timeliness and quality of employment statistics.

I think all of these are areas where we need the most accurate figures we could possibly get. I hope that we are able to restore those funds so that you will not be cut back further in the job that you are trying to do.

I would also like to compliment Commissioner Norwood for the excellent job she has done as the head of the Bureau of Labor Statistics. I think it is a particularly difficult job right now with the very changed economic situation and the basis on which we are operating the Government right now. It just points up the importance of having at this time not a cut in your operation but, if anything, I would think an expansion so that we could keep up with this changing, very flexible, mobile economic situation in which we find ourselves right now.

I hope that these supplementals will be considered very favorably and I know that is not the subject of the hearing this morning, but it is apropos to the work you are doing and I thought it was appropriate to bring it up at the hearing this morning. Mr. Chairman, I thank you again for your consideration.

[The prepared statement of Senator Glenn, with attachment, follows:]

PREPARED STATEMENT OF SENATOR GLENN

Mr. Chairman, thank you very much for your courtesy in allowing me to make a statement at your Subcommittee hearing this morning. I regret that I cannot stay for the remainder of the hearing, but I did want to express my view of a problem that has arisen with respect to the budget for the Bureau of Labor Statistics, and to express it particularly in the presence of Commissioner Norwood.

I think we are all aware, Mr. Chairman, of how important the work of the Bureau of Labor Statistics is to the proper functioning of many federal programs as well as to the proper understanding of what our economic situation is, especially with respect to unemployment. For example, the payroll survey done by the Bureau is particularly important in times of economic stress because it tells how many people have been laid off in various sectors, even when the gross employment statistics may indicate an increase in the total number of jobs. As far as the Consumer Price Index calculation is concerned, I have no doubt that the number of lawsuits in the country would rise significantly if the Bureau were to lose its ability to accurately compute the CPI as a result of lack of material or human resources.

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[1] See p. 3.

Last year the bureau, along with other agencies, took a 12 percent cut in program funding for fiscal year 1982. This cut involved elimination or severe curtailment in each major program area and a reduction of close to 200 people. I would like to submit for the record the list of programs which have been reduced or eliminated due to the 12 percent reduction.

As you know Mr. Chairman, in reaching agreement last Fall on the Continuing Resolution to fund federal government agencies, the Congress and the Administration agreed to an additional across-the-board percentage reduction from the lower of the House or Senate levels for each agency. This additional cut presents a severe funding problem to the Bureau which could threaten the accurate computation of our basic national indicators. BLS is currently faced with a budget deficit of approximately $9.1 million for fiscal year 1982. The Agency is asking for a program supplemental of $5.7 million and a $3.4 million pay supplemental. If this additional money is not provided to the Agency, it is my understanding that the only option the Agency has for dealing with the deficit would be to furlough its entire staff for 6 to 9 weeks. Among the possible adverse actions that could follow failure to approve the supplemental request would be:

(1) A portion of the Current Population Survey would be suspended, and all quality control data collection would be suspended.

(2) Survey activities undertaken to maintain the accuracy of the CPI outlet sample would be suspended; some actual data collection would be suspended in all price programs.

(3) Contracts with state agencies in the BLS payroll and other establishment-based surveys would be reduced markedly. This would affet the quality and timeliness of the payroll employment and earnings data used in the Employment Situation release each month.

In addition to all this, I am told that any furlough plan would definitely adversely impact such programs as the Consumer Price Index, the Unemployment and Employment Data, the Producer Price Index, and the basic productivity and wage statistics.

Mr. Chairman, I am as much in favor as anyone of trying to find a way to deal with the presently projected budget deficit, but we are not going to save any taxpayers money by cutting out the collection of basic information which is needed in order to efficiently run government programs. The lawsuits that might follow the cutting of corners by the Bureau of Labor Statistics in order to compute the Consumer Price Index would probably end up costing more than the amount of money needed to keep the Agency on track.

I realize Mr. Chairman, that this issue is not the subject of today's hearing by your Subcommittee, but I believe it is an important issue that needs to be addressed and it is my intention of communicating my views on this to the Appropriations Committee, which will be taking up the Supplemental Appropriations Bill for the Bureau of Labor Statistics within a few days.

I also wish to compliment Commissioner Norwood for the excellent job that she has done as Head of the Bureau of Labor Statistics. There are times when the bearer of bad news is sometimes blamed for delivering the message. We need to know what's happening with respect to unemployment in South Succotash as well as in our home states and we also need to know that those government programs which depend upon careful calculation of economic statistics are running smoothly and efficiently. What happened to the Bureau is a perfect example of what happens whenever a meat-ax approach is taken to budget cutting. So I hope, Commissioner Norwood, that as we finally come around to a resolution of the fiscal year 1983 budget, that the meat-ax approach will be rejected and that agencies such as yours will be able to continue to do the work that benefits all the American people without major disruption.

U.S. BUREAU OF LABOR STATISTICS

Programs reduced or eliminated in the 12 percent reduction:

1. Labor Turnover survey program eliminated.
2. Current Population Survey—May supplement on multiple jobholding eliminated.
3. Current Population Survey—redesign to take account of 1980 Census changes delayed.
4. Current Population Survey—Number of households added to improve Local Area Unemployment Statistics reduced.

5. Research to improve State and local area unemployment statistics eliminated.
6. BLS Family Budget program eliminated.
7. Consumer Price Index for Fairbanks, Alaska, eliminated.
8. Pricing samples for Consumer Price Index for Wage Earners and Clerical Workers (CPI-W) reduced. Same prices will be used for the All Urban index (CPI-U) and the CPI-W.
9. Planned revision of Producer Price Index delayed.
10. Planned completion of Export and Import Price Indexes delayed.
11. Work Stoppage statistics sharply reduced. Coverage will be limited only to strikes covering 1,000 or more workers.
12. Five Industry Wage Surveys eliminated.
13. Analysis of Collective Bargaining Agreement provisions eliminated.
14. Survey of Labor and Materials Requirements in the Construction Industry eliminated.
15. BLS economic growth and occupational outlook program reduced.
16. Reduction in number of occupations in the Occupational Outlook Handbook.

OPENING STATEMENT OF SENATOR MATTINGLY

Senator **Mattingly**. Thank you, Senator Glenn.

We begin hearings today on the Consumer Price Index, or "CPI", that is compiled by the Bureau of Labor Statistics. There has been a lot of controversy over the CPI, how it is compiled, the data included and, most importantly, over the CPI's accurate measure of the cost of living for the purpose of indexing Federal programs. I hope during the course of these hearings to highlight the problems with the CPI as it is currently calculated, and to arrive at some solution to those problems. The Bureau of Labor Statistics has been computing some form of consumer price index since 1919. Despite the fact that the Bureau considers the CPI a "price index" and not a cost-of-living index, Congress and others inside and outside of government have used it as a base for their yearly adjustments in program spending and wage levels.

There are 44 Federal programs indexed to the CPI. The accuracy of the CPI's real measurements of the cost of living has become vital to the Federal budget process. The benefits and paychecks of millions of American citizens are based upon the CPI. Every percentage point increase in the CPI adds $2 billion in Federal spending.

The acuteness of the problem can best be illustrated by this fact: If we continue to index programs through the CPI as currently calculated by the year 1990 some have said that 93 percent of the revenues coming into the Federal Government would go to indexed programs. But the problem is not with the Consumer Price Index as it stands alone, but as it is used by Congress as a measurement of inflation.

The most commonly mentioned problem of the CPI as it is used in that manner is the way in which the index reflects the cost of housing. It has been estimated that the current method has caused the CPI to overstate inflation by 25 percent in the last 10 years. The change proposed by the Bureau of Labor Statistics in the important CPI-W index—the index to which most Federal programs are tied to—would compensate for the inaccurate measure of housing costs, but will not take place until 1985. Thus, Congress will continue to use an admittedly flawed index for programs that consume a major portion of the Federal budget. But the housing component is not the only problem that many have with the Consumer Price Index as a basic measurement of the cost of living.

For example, the market basket of goods and services measured by the Bureau of Labor Statistics include such costs as the price of private tuition, of elementary and secondary education, the cost of sirloin steaks and the price of mixed drinks at the bars. These are not at all relevant to the Federal programs and index that reflect these costs. The largest share of the indexed programs benefit the elderly and it is true that they will be the most vulnerable to the destructive effects of inflation.

There are many who propose a retirees index which would more accurately reflect the cost of goods and services by the elderly. I believe there is much to be said for this approach. The retirees index could take into consideration items overstated in the current CPI and areas understated such as medical care. There is also the problem of the current deflation and its effect on the CPI as it is now calculated. We need to take action on the CPI problem soon. The exaggerations of the current CPI are magnified each year.

The billions of dollars erroneously added last year are themselves indexed for an increase this year and during the course of these hearings I hope to answer these questions: Is the CPI, as currently calculated, an accurate measure of inflation? Is the CPI as currently calculated misused by the Congress? Has the CPI as currently calculated caused overcompensation for index programs?

And if the current CPI is, indeed, flawed, should it be changed? Realizing the Bureau of Labor Statistics intends to change the CPI in the future, what immediate changes in the interim would be fair and equitable?

Finally, I would like to add that any legislative proposals that might come out of these hearings will be shared with the Finance Committee which has final jurisdiction over indexation of Federal revenue. I would like to thank you for your attention and now would like to call our first witness.

I would like to call Dr. Janet Norwood, the Commissioner of the Bureau of Labor Statistics. She has written extensively on many of the issues we hope to address today.

We are very honored to have her before us. I believe last October she announced the Bureau of Labor Statistics would change the method by which housing costs and CPI are calculated. Dr. Norwood, I am very happy to have you with us this morning. If you would like to begin.

TESTIMONY OF JANET NORWOOD, COMMISSIONER, BUREAU OF LABOR STATISTICS

Ms. NORWOOD. Thank you very much, Mr. Chairman.

I welcome this opportunity to appear before you to discuss the characteristics of the Consumer Price Index which is used to index a large, and a growing, proportion of Government expenditures.

These issues are extremely important, and I want to be sure that the Members of Congress understand exactly how the Bureau of Labor Statistics constructs the CPI. I do wish to point out that as Commissioner of Labor Statistics, I must leave the policy issues to those in the administration and the Congress who have responsibility for policy determination. My role is to comment on the technical and conceptual questions involved in the measure used for escalation.

These are issues of very great concern to us at BLS. Generally speaking, the purpose of most indexation is to adjust payments in order to keep purchasing power constant. The CPI, as a major economic indicator designed to measure changes in consumer prices and purchasing power, has commonly been chosen as the primary indexing mechanism. But in discussing the CPI as the tool for indexation, I believe it is important to focus on two criteria for judging whether the CPI should be used in a particular escalation agreement.

First, how well does the CPI achieve its stated objectives of measuring changes in the cost, at market prices, of a representative market basket of goods and services. And, second, how relevant is this objective for the particular escalation agreement?

I would like to discuss today a few issues that surround these basic criteria.

First, the fixed market basket. The CPI is constructed by obtaining the prices each month of a set of goods and services purchased in the base period. This market basket is based on a survey of consumers conducted during these years. That is, it represents what people actually spend their money on.

BLS practice has been to hold the weights for the mix of goods and services purchased during a base period constant until a major revision takes place, generally about every 10 to 12 years. The market basket is kept constant deliberately in order to isolate price changes from changes which may occur in living standards.

This issue in recent years, as prices have continued to climb, has been discussed because many people have argued that the CPI market basket does not adequately represent current experience.

Historically, however, differences in weighting patterns have not usually created large differences in price index measures. BLS research suggests that between CPI revisions in the past, the effect of consumption shifts on price measurement has been no more than a tenth or so of an index point per year.

Of course, past experience on this question may not be conclusive, especially in the most recent years when inflation has been running at double digit rates and large changes in certain prices have been experienced.

Another way to gain perspective on the effect of weighting patterns on price index measurement is to examine the Commerce Department deflators for personal consumption expenditures [PCE] which are published in alternative versions with different weights.

In fact, there are several versions of the deflator. The two most relevant versions of the PCE deflator for 1981 differ by only one tenth of a percentage point. That is, the PCE deflator using 1972 weights and the PCE deflator using 1980 weights both record similar measures of inflation during 1981, 9.1 and 9.0 respectively.

Those are two price indexes that differ from each other only in weights and I would emphasize that most of the detail price data used in the PCE indexes come from the CPI.

There are many differences between the PCE deflators and CPI. However, the data I have seen on the fixed market basket issue suggest that the effect of weighting differences on the CPI measurement is probably considerably less than what it has been speculated to be in some parts of the press and in academic circles.

Nevertheless, even if comparison of indexes with alternative weighting schemes indicates that use of a more current market basket would not have had as large an impact as some have suspected, it is important to recognize that this result need not continue in the future.

For more than three decades, the Bureau of Labor Statistics has recognized the need for continuing consumer expenditure surveys, and I am pleased that we have begun to conduct such a survey. When the survey has been fully set in place, we will be able to monitor the degree to which consumption patterns are changing, and to have in hand the data required for future revisions of the CPI.

Now, there have been several other issues that have been raised. One, for example, involves taxes. Another involves the treatment of imports. The CPI, like any other index number, is essentially a statistical construct designed to answer a specific question.

Unfortunately, the precise question to be addressed in indexation is not often stated explicitly and the same index can be construed or, in some cases, misconstrued as an answer to a number of alternative questions.

In the case of taxes, the CPI includes only those taxes that are directly associated with the purchase of goods and services in the CPI market basket. This treatment of taxes is consistent with the CPI focus on the expenditure necessary to purchase the market basket. It is entirely possible to construct an index which answers a different question and which would treat taxes in a different way and, in fact, that has been done in some other countries.

But the ultimate solution to this kind of question is not to change the CPI but rather to understand the question to be answered in indexation and, if an index with different tax treatment is desired, to construct one.

Construction of alternative indexes frequently does present a number of difficult practical problems but alternative indexes may nevertheless be useful as a response to the increasingly complex uses to which the CPI is put.

Another issue that has been raised frequently, particularly since the drastic increase in relative prices of petroleum-based products, has been questions about the treatment of imported goods in the CPI. It is sometimes argued that increases in imported prices should be factored out of the index because these increases are exogen to the domestic economy.

If the participants in an escalation agreement decide that they do not wish to compensate for increases in the price of imported goods, then they are deciding, for their purpose, the the CPI does not address the appropriate question and they may seek an index which gets out in some way the effective increases in imported prices.

There are, however, problems in constructing an index which eliminates the indirect as well as the direct effect of such prices. The direct expenditures for such items as gasoline and other petroleum-based products can be eliminated relatively, easily. In fact, we do publish some indexes now as part of the CPI system which exclude the direct impact of energy price changes.

It should be emphasized, of course, that imports are part of consumption and that import prices belong in an index that measures living costs. The fact that parties to a particular indexation agreement might wish to exclude import prices does not mean that the CPI is in error in carrying out its purpose of measuring consumer prices.

The third question frequently raised is the construction of an index for a particular population group, the so-called family of indexes issue. It should be recognized that the rate of inflation can vary across households and that the average may not represent the experience of any individual subgroup.

In particular, differences among households may be related to such characteristics as age and income level. We do not know the extent of this variation or the degree to which it is systematic. But even if we assume that all households experience the same change in average price level, it is possible that their need for indexation will depend on what happens to their total income.

The CPI measures the change in total expenditure necessary to purchase a set of goods and services. To the extent that the percentage of income provided by indexed programs varies among households, the degree to which households are insured against inflation by indexation will also vary.

In other words, the change in a household's living standard as a result of inflation will depend on how all of its income sources vary with inflation. Thus, even in a very simplified case, living standards could change substantially despite escalation of benefits by a very accurate index.

I raise these issues relating to the target population because they pertain directly to recent suggestions that special indexes might be designed to index payments to subgroups of the population, such as the elderly.

These issues are potentially just as important in designing an effective indexation program as those technical issues like the use of a fixed market basket which are important for all uses of the index.

We do not know whether an index for a particular group of the population would produce results that are very different from the CPI for all urban consumers. A whole series of important issues would have to be clarified before any empirical testing could even be done. For example, policymakers would have to prescribe the definition of the group to be represented. It is rather interesting that, in all the discussions I have had on this issue, no one is quite willing to give me a specific definition of who the elderly or the retired or the social security recipients are.

I believe also that a good deal of experimental work needs to be done because we would need new samples of market basket items, different outlets and, probably different areas of the country for price collection.

In October of last year, I provided notice to users that the Bureau of Labor Statistics would change the homeownership component of the Consumer Price Index to a rental equivalents measure. And I would like to submit a detailed statement for the record which describes what that change is and reasons for it.[1]

Basically, effective with data for January 1983, which would be published in February, the homeownership component of the official Consumer Price Index for all urban consumers will be changed to a rental equivalence measure and effective with data for January 1985, the CPI for urban wage earners and clerical workers (CPI-W) will be revised to a rental equivalance measure.

The new homeownership components will be linked into each CPI at the end of the year preceding the change in a technical manner similar to that which has been used in previous major revisions of the index.

The Bureau will continue its efforts to improve the rental equivalence measure by refinements in procedures and calculation methods and eventually through supplementation of the rental sample.

The last item that I would like to comment on very briefly is the need for the next comprehensive revision of the Consumer Price Index. The Bureau of Labor Statistics staff has begun planning for this project. Among the most important items which would need to be covered in such a revision are, first, the market basket for the CPI should be updated to reflect changes in consumer spending that have taken place since the 1972-73 period currently used as a reference base.

Second, the results of the 1980 census of population should be incorporated in the index to account for the population shifts that have taken place since 1970.

Third, the rental equivalent sample to be used to measure homeowners' shelter costs should be further expanded and improved. In fact, the entire rent sample should be redesigned to represent the population as measured in the 1980 census.

Fourth, a schedule for systematic replenishment of price reporter samples should be established for those components of the CPI that currently are not on one.

And, finally, the CPI computer system should be modernized, data collection techniques should reflect more current state of the art technology and additional research on index measurement issues should be undertaken.

Mr. Chairman, I am very pleased to be here this morning. I believe strongly that the CPI is a very good measure and that it achieves its intended objective. I believe that the homeownership component changes will make the CPI a better measure.

In the last revision of the CPI completed in 1978, we introduced modern statistical sampling techniques throughout the entire index and I think we have one of the best consumer price indexes in the world as a result.

I will be glad to answer any questions you may have.

Senator MATTINGLY. Thank you, Dr. Norwood.

Prior to asking you questions, I would like to ask Dr. Rivlin if she would come forward and make her statement. I want your statement to be full and detailed since you are the one who compiles the figures. I have asked the balance of the witnesses to summarize their statements so we can get to the question and answers as rapidly as possible.

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[1] See p. 30.

Dr. Rivlin, it is good to have you here.

TESTIMONY OF ALICE M. RIVLIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Ms. RIVLIN. I am delighted to be here, Mr. Chairman. I feel much more comfortable answering questions about the Consumer Price Index when I have the Nation's leading expert on that subject sitting on my right.

Mr. Chairman, reductions in cost-of-living adjustments for Federal entitlement programs have figured prominently in discussions of efforts to reduce projected budget deficits. The reason is clear: The budget costs associated with COLA adjustments are very large. COLA adjustments for fiscal year 1982 through 1985, for example, will cost about $112 billion.

Besides the implications of COLA changes aimed at immediate relief of our budget problems, a lot of attention has been devoted to longer run reforms of Federal COLA procedures. My testimony today will focus on two prominent reform proposals: First, the replacement of the current measure of homeownership costs in the Consumer Price Index with a measure that more accurately reflects the price of housing services; and second, the possible construction of a special Consumer Price Index for the elderly as a basis for making COLA adjustments for Federal entitlement programs.

My statement will make three major points. First, the current CPI is a flawed measure of the cost of living largely because the homeownership component is a poor measure of the price of housing services. Replacing the current measure of homeownership costs with a rental equivalence measure would provide us with a better measure of the price of housing services. The decision to replace the current homeownership component in the CPI with a rental equivalence index should provide us with a superior measure of the cost of living.

Second, and this is bad news, replacement of the current CPI with a revised rental equivalence CPI as the COLA index for Federal entitlement programs, although justifiable on conceptual grounds, will not necessarily result in any net budget savings. The rate of inflation measured by the revised index could be higher or lower than the rate measured by the current CPI depending on prospective changes in house prices, house rents, and mortgage interest rates. Indeed, there is considerable likelihood that the revised CPI could exhibit more inflation than the current CPI for the next year or so at least. Accordingly, proposals aimed at pushing forward from 1985 to 1983 the date at which Federal entitlement programs are scheduled to be indexed to the revised CPI could result in budget losses, not budget savings.

Third, there is little hard evidence to support the view that the CPI misrepresents the cost of living for the elderly. The data, imperfect though they are, suggest that differences between the economywide CPI and a special index for the elderly would have been small for the 1970's. Alternative treatments of the cost of homeownership would not have affected this result materially.

Criticism of the current CPI centers on its treatment of homeownership costs. Ideally, a cost-of-living measure should include only the actual costs people incur in meeting their shelter needs. One approximate measure of the shelter cost of a home is its rental value: when people pay rent for a home, they have "nothing to show for it" at the end; each month's rent simply pays for the services consumed currently. The current CPI measures more than the shelter cost of the home to the homeowner. Included in the current CPI market basket is the purchase price of the home, an estimate of its financing costs, taxes and insurance, and the cost of house maintenance. In return for these costs, homeowners do get more than just places to live. They get an investment with special advantages as a tax shelter and as a hedge against inflation; they frequently do have "something to show" for the money they have spent. To include the investment value of homeownership in a cost-of-living measure is a distortion. We do not include the costs of stocks and bonds that people buy in the CPI measure of their cost of living; neither should we include the investment value of homeownership.

As Dr. Norwood has said, in an effort to obtain a truer measure of the cost of shelter services, the BLS has announced that it intends to replace the current treatment of homeownership costs in the CPI with a rental equivalency measure—in effect, BLS will replace the current homeownership component with a rent index based on a sample of dwellings that is, as nearly as possible, representative of the types of homes occupied by owners. The revised treatment is to be implemented for the CPI-U in 1983; the CPI-W, the index currently used for social security COLA's, is scheduled for revision beginning in 1985.

Although the revised treatment of homeownership costs presents difficult measurement problems, the conceptual attractiveness of the rental equivalency approach is widely acknowledged. The inclusion of only the shelter services of a home reduces the total relative importance of homeownership costs from about 31 percent in the current CPI to about 21 percent in the revised CPI. This 10-percentage-point reduction in weight is a measure of the investment value of homeownership that is inappropriately referred to as a component of the cost of living in the current CPI. The reduced weight means that the revised index will be considerably less sensitive to housing market developments than the current CPI.

Substitution of a rental equivalency measure for the current treatment of homeownership costs would have made a substantial difference to the behavior of the CPI over the past decade. The experimental index goes back to 1967. To the extent that the cost of homeownership embodied in that experimental index accurately measures the cost of shelter services of a home, the official CPI overstated the actual rate of inflation by 0.7 percentage points per year on the average since 1967 as shown in figure 1.[1]

The main determinants of the differences between the CPI and the experimental indexes are shown in figure 2.[2]

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[1] See p. 41.

[2] See p. 42.

Over the decade, house prices rose by almost 20 percent more than the prices of other goods and services.

Over the course of the 1970's, rents rose by 10 percent less than the average of other prices.

And over the same period, mortgage rates rose dramatically, from the neighborhood of 8 percent at the beginning of the decade to rates of about 16 percent at the end.

Higher mortgage rates and higher house prices tended to increase the current CPI but had no direct impact on the experimental index. Lower rents reduced the experimental index by more than they did the current CPI. All these factors led to a growing gap during the 1970's and early 1980's between the two indexes.

The budgetary impact of this apparent overstatement of inflation has been substantial. Counting all entitlement programs, the annual excess cost of the overstatement of inflation since 1974 approaches $8½ billion.

Although the trend differences between the CPI and the experimental index have been sustained for an extended period of time, it would not be appropriate to extrapolate those differences into the future. Indeed, many people think that the revised CPI will exhibit more inflation than the current CPI for the next year or two at least. Beyond that time frame, however, it is impossible to determine whether the revised CPI will show more or less inflation than would have been shown by the current measure.

The relative prospective rates of inflation as measured by the current CPI and the revised CPI will be determined almost exclusively by the prospective rates of increase of three price components—mortgage rates, house prices, and rents. While some of the past trends in these components are likely to continue into the 1980's, with possible interruption during the current recession and subsequent recovery, others are likely to be reversed.

Mortgage rates are not expected to continue rising as they did in the 1970's and early 1980's. The only basis for continuing long-run increases in mortgage rates would be an accelerating rate of inflation. However, almost every forecast, including ours, projects lower rates of inflation in the future.

The recent softness in house prices could persist for some time into the future, aided, in part, by a continued slump in the housing market. However, because the demographic factors underlying housing demand will remain strong through the mid-1980's at least, house prices are likely to continue to increase faster than other prices during the decade of the 1980's, as a whole.

It is very uncertain at this time whether future rents will rise or fall relative to the prices of other goods and services. In any event, there is no reason to anticipate further persistent declines in rents relative to house prices.

Other things remaining equal, if mortgage rates fall this will lower the growth of the current CPI relative to the revised index; if house prices rise faster than those of other goods, the current CPI will tend to grow faster than the revised index; and given the greater weight of the rent index in the revised CPI, an increased pace of rental prices would raise the growth of the revised index relative to the current CPI.

A great many factors will affect future movements in mortgage rates, house prices, and rents; these are analyzed in the appendix to my prepared statement. Taking them together, there is considerable likelihood that declining mortgage rates would pull the growth of the current CPI below that of the revised index in the next year or two. Beyond that period, CBO's best guess is that inflation rates calculated using the current measure of homeownership and the rental equivalence measure will not differ from one another substantially.

Finally, is there a need for a special consumer price index for the elderly? A lot of interest has centered around the idea of such an index. Although the case for a special index for the elderly is attractive conceptually, two considerations need to be kept in mind. First, Federal entitlement programs provide benefits to more than just the aged. The elderly are the largest subgroup of recipients, but as of November 1981, almost one-third of all social security beneficiaries were under the age of 65; and almost one-fourth were under the age of 62. Second, because spending patterns vary so widely among the elderly—reflecting, in part, the marked differences in economic circumstances faced by the aged—it is not clear that a special measure of the cost-of-living change experienced by the elderly would be much better than the current CPI.

This brings us to the second issue—the degree to which the economywide CPI misrepresents the extent of inflation experienced by the elderly. We know that the elderly, on average, spend a greater proportion of their income on food at home and on medical care, although inadequate acccount has been taken of the complex medical insurance situations facing the aged; we know that the elderly spend a lower proportion of their income on food away from home, on transportation, and on recreation; and we know that they are more likely to own their homes outright.

Despite these spending pattern differences, the evidence, imperfect though it is, suggests that differences between the economywide CPI and a special index for the elderly would have been very small for the decade of the 1970's. Consumer price indexes incorporating expenditure weights more appropriate to the elderly population tend to move in a manner very similar to the movement of the economywide CPI, as shown in figure 3.[1]

Importantly, the differences between these two indexes are not particularly sensititive to changes in the treatment of homeownership costs. This meets directly an often repeated criticism that movements in the cost of homeownership as measured in the current CPI are of little relevance to groups such as retirees, since the frequency with which they purchase houses is much less than for urban consumers in general. Thus, although the revised index will more accurately reflect the expenditure patterns of the elderly, the rate of inflation for the elderly is little affected.

To represent even better the expenditure patterns of the elderly and other recipients of entitlement program outlays, a case can be made, on conceptual grounds at least, for replacing the CPI–W, the current COLA index, with the CPI–U. This is because the CPI–W is based on the expenditure patterns of urban wage and clerical workers only, whereas the CPI-U is based on the expenditure patterns of all urban consumers, including retirees.

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[1] See p. 47.

That concludes my statement, Mr. Chairman. I will be glad to join with Dr. Norwood in answering your questions.

Senator MATTINGLY. Thank you both very much.

First I would like to ask a question of Dr. Norwood and if you would like to comment, Dr. Rivlin, you can.

Do you feel that the present method of calculating CPI with homeownership in it is statistically incorrect? In other words, from what I gather from everybody's comments, it does not belong in there, is that correct?

Ms. NORWOOD. I believe very strongly that conceptually the CPI should attempt to measure the cost of shelter and should exclude the asset value of purchased houses. It is for that reason that we are planning to improve the CPI by making a change in the homeownership component next year for CPI-U and then somewhat later for the CPI-W. I think it is important to remember, Mr. Chairman, that this is an issue discussed by the Bureau of Labor Statistics for more than 10 years. In fact, we have had a number of discussions with a variety of users of the index and I think there is now some agreement, at least, that this change should be made.

Senator MATTINGLY. Yes; right. Dr. Rivlin, it would make a better index, then, if we changed the CPI homeownership component, do you agree with that?

Ms. RIVLIN. I agree with what Dr. Norwood has said. In principle, we should measure the current cost of shelter and take out the investment component of homes. There are different ways of doing that. The rental equivalence is not the only way. It is probably the most practical.

Senator MATTINGLY. Let me ask you something, Dr. Norwood. Do you feel a fairly good estimation of the change in the price level could be determined more frequently with less data than is currently gathered by your bureau?

Ms. NORWOOD. I am not sure that I understand the question. Less frequently?

Senator MATTINGLY. Could be determined more frequently with less data?

Ms. NORWOOD. No, I don't believe so. There is, of course, a tradeoff between the national data, the sample sizes for the national index, and the local indexes.

One could construct a national index only with no local data at all probably with somewhat less data.

Senator MATTINGLY. You have the administrative authority to change the composition of CPI; isn't that correct?

Ms. NORWOOD. We have responsibility for compiling and measuring consumer prices and analyzing them.

We do have the authority to make changes in the index. I think it should be understood that the CPI is an important measure and clearly cannot be changed in a vacuum. There has to be some general understanding and some agreement by at least many users before a change can be made.

Senator MATTINGLY. But the authority rests in the Bureau of Labor Statistics.

Ms. NORWOOD. I am not a lawyer. You will have to ask our solicitor about that. But so far as I understand it, the decisions that we have made are within our authority.

Senator MATTINGLY. In other words, to change the CPI, like taking the homeownership out now and further changing it in a couple years from now, is within your authority?

Ms. NORWOOD. Yes, but only after consultation with advisory groups, with the public, with the Congress, and so on.

Senator MATTINGLY. Dr. Rivlin, you made a comment that the CPI had been overstated by seven-tenths of a percentage point since 1967. What do you estimate this has cost the Government since 1967?

Ms. RIVLIN. Indexing of the social security began in 1974 with the 1972 amendments. Indexing of other programs began at other times. I don't think it goes back to 1967.

Senator MATTINGLY. But the seven-tenths amounted to $8½ billion; is that what you are saying?

Ms. RIVLIN. Yes, the difference between the two indices over the period since 1974 would have amounted to about $8½ billion in fiscal year 1981.

Senator MATTINGLY. Was the CPI, Dr. Norwood, as created ever intended to be used as it is now by the Congress?

Ms. NORWOOD. It is rather interesting since the Bureau of Labor Statistics will soon be 100 years old, I have been delving into some of our historical records and have looked at the origin of many of our programs. There was a CPI that began in 1908 and because it did some things that some people didn't like, it was done away with. It reappeared after World War II and its basic purpose at that time, in addition to measuring price change, was for escalation of some collective bargaining arrangements.

In recent years, it has been the measure that has been used for all kinds of indexation programs, many of which it was not created for. The purposes are certainly ones that the index was not created for.

Senator MATTINGLY. Dr. Rivlin, what do you think would be the effect of the current deflation, as is now going on, upon the already flawed CPI? In other words, with a price increase scheduled beginning this July, what impact is that going to have dollar-wise?

Ms. RIVLIN. We had been estimating that the current COLA, which is based on the first quarter of this year over the first quarter of last year, would be about 8.1 percent. That now looks a little too high. We don't have the fiscal numbers yet. The most recent guess that I have heard was 7.6 percent, but Dr. Norwood would be better able to estimate that than I.

Ms. NORWOOD. As you know, I don't guess, and I really rely on Dr. Rivlin all the time, but I would say that if one looks at the price trend of the CPI-U and compares that to the experimental CPI-X1, you see that for the last year they have come much closer together because of the substantial slowdown in the CPI-U.

Senator MATTINGLY. What do you think, Dr. Rivlin, is going to be the money impact in July if you went on the assumption of a COLA increase of 7.6 percent, of whatever it may be, versus the going inflation rate at that time?

Ms. RIVLIN. I will have to supply that for the record because I don't have an exact number.

Senator MATTINGLY. I had heard something. I won't give you figures. That wouldn't be fair, either. We would appreciate it if you could get those figures because there obviously is going to be a large dollar amount; isn't that correct?

Ms. RIVLIN. Yes.

Senator MATTINGLY. Somebody made the comment about there are small differences between the unit percentage points of error. The small differences, I think you would both agree, amount to big dollars, don't they, the impact on the budget?

Ms. NORWOOD. Mr. Chairman, I quite agree with that. I guess I would object to the use of the word error.

Senator MATTINGLY. I will drop that word out of there then.

Ms. NORWOOD. The situation is that you have alternative measures of price change that measure different things and they behave in different ways.

Some years ago, President Ford proposed to the Congress that they pass legislation to use the CPI-U, rather than CPI-W for Federal Government entitlement programs. Some time later, President Carter, in a report to the Congress, proposed that CPI experimental index X-1 be used for Federal Government entitlement programs and that was not passed. We can look at all of these different alternatives and we can talk about what the differences would be, but they are different measures.

Ms. RIVLIN. If I may come back to the number, the consequence of not having a COLA change in July or during fiscal year 1983 on all programs would be a saving of about $19 billion in fiscal year 1983.

Senator MATTINGLY. What would it be if—not talking about having COLA—but would it reflect the current inflation rate at that time——

Ms. RIVLIN. To change the index?

Senator MATTINGLY. Yes.

Ms. RIVLIN. That would make a relatively small difference, on the order of half a billion.

Senator MATTINGLY. In the interim period, prior to any change of the CPI, could there be a change that you could administratively do that would reflect some of the known inequities in there that could probably be instituted sooner than what you have now been talking about for dropping the homeownership to change to rental equivalence?

Ms. NORWOOD. I think the real issue is whether the Congress wants to make any change in its use of the index. The Congress could use the CPI-U and it could use the CPI-experimental X-1, should it wish to.

Senator MATTINGLY. Is that up to the Congress or is that up to you?

Ms. NORWOOD. That is legislation. One of the problems that we have, Senator, is that we produce indexes and we produce many other numbers. If you get away from the price area, for example, we produce local area unemployment statistics.

Some of those data for very small areas have a great deal of error associated with them. They are based on administrative data and they present great difficulties.

We have explained that. In fact, we have gone so far as to say a table of random numbers might do as well, but we have done the best we can to improve them and I think we have made some improvements. Nevertheless, they do appear in legislation and I can understand the reasons for that, but it is really the use of the data that at times is unfortunate or produces unfortunate results, there is more inflation than people expect and then people attack the statistical series itself.

The CPI and all of our data are what they say they are. They are put together in a particular way, they are produced to answer particular questions. Now if the questions are different, maybe there should be a different measure.

Senator **Mattingly**. I will ask Dr. Rivlin this question: If inflation is going to be zero in June, or July, how much would the Federal Government be paying out? That would be the $19 billion, I guess, wouldn't it?

Ms. **Rivlin**. It would have to have been zero already.

Senator **Mattingly**. Because that gets into the lag time; am I correct?

Ms. **Rivlin**. Yes; that's right. The COLA for July is based on a period that is already history, although we don't have all the historical statistics together yet. If we had zero inflation between the beginning of this year and the beginning of 1983, that would be reflected in the 1983 COLA. You wouldn't get any benefits until fiscal 1984. That would be of the order of $20 billion.

Senator **Mattingly**. Don't you both agree that with inflation dropping so rapidly that the lag time now plays a very, very important role in the compensation that is going to be paid out on index programs whenever those periods come up, March or July, whenever the programs are indexed, probably more so than they have been going in the other direction.

Ms. **Rivlin**. Certainly, if inflation does come down, as we all hope it will——

Senator **Mattingly**. Which it has right now. I haven't looked at the morning paper.

Ms. **Rivlin**. The lag will make a more obvious difference. On the other hand, the social security beneficiaries would argue that they have already paid these prices. They would say that they need to be compensated for the rise in cost of living that has in fact occurred.

Senator **Mattingly**. Let's talk about all the 44 indexed programs—not narrowed down to social security, but then all. The records are clear that there has been overcompensation through the years. Maybe the lag time could be shortened. I am not saying we should try to get any money back, but the facts do justify a shortening of the lag time.

Ms. **Norwood**. I suspect some of your witnesses today might disagree with that conclusion, but it is certainly proper for the policymakers to consider that kind of adjustment they want to make, whether it be over the past year, the price change over the past year or the past quarter or the current month.

Senator MATTINGLY. I don't want to put you on the spot because I keep getting confused with which one is a policy matter and which one is a statistical matter, but wouldn't it almost seem fair and equitable to consider some change in the lag time, knowing historically what we have done in the Congress, not you all, but what the Congress has done by using the index, and the huge impact of overcompensation? The statistics show that maybe a shortening of the lag time is justified. Is one going to say yes; one no?

Ms. NORWOOD. Let me just say that I don't think that is a yes-no answer question. It depends really on what you want to do. My experience in explaining the CPI to users has been that those who are in a position of making payments because of the change in the CPI who frequently had not forecast such high rates of inflation feel that the CPI is much too high and that anything that can be done to shorten the period or to pick out a better period or to change the index would be very valuable. On the other hand, those who are receiving payments that are indexed by the CPI feel also sometimes that they are not getting enough and so it really depends on where you are coming from.

Senator MATTINGLY. I guess that is the reason why I am getting in the arena of—I think that is what we need to resolve. In fairness, and in equity, when you join two debates together, there could be justification and not strictly from a budgetary standpoint, but an equity and fairness standpoint.

Ms. RIVLIN. Let me try to separate two things. I think one can argue on an equity basis that recipients of indexed benefits have made out relatively well over the last few years, both because the current CPI has probably exaggerated the real cost of living and because they have been better protected against inflation than wage earners have been. Any way you measure it, the indexed benefits have kept up with inflation and wages haven't. So that on fairness grounds, one could argue for some cut. I don't think that necessarily argues for any particular statistical change. You could do something quite arbitrary, like saying we will use the CPI minus 3 percent or minus 4 percent and justify it on the basis that everybody has to share in cutting the budget and this is one way of cutting back on the indexed benefits in partial compensation for the fact they have increased faster than other people's wages and benefits.

The question of cutting the lag time ought to be viewed as a statistical matter. It is very hard to get statistics that are both very current and accurate, so that if you cut the lag time to the quarter just past one might have more problems than doing it with more lag. Again, Dr. Norwood is a better expert on that than I.

Senator MATTINGLY. I would like to include for the record following my statement a copy of the indexed programs and also those things included in the market basket so that it is part of the record.[1]

Do you all have any other comments you would like to make?

If not, I appreciate you both coming today. I think you are both doing excellent jobs, and I hope the Congress can arrive at a decision with the two of you that will provide fairness and equity to not only the index programs but to the taxpayers of the United States.

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[1] See p. 232.

Thank you.

[The prepared statements of Ms. Norwood, with attachments, and Ms. Rivlin, with an attachment, follow:]

STATEMENT OF DR. JANET L. NORWOOD
COMMISSIONER
BUREAU OF LABOR STATISTICS
BEFORE THE
COMMITTEE ON GOVERNMENTAL AFFAIRS
SUBCOMMITTEE ON CONGRESSIONAL OPERATIONS AND OVERSIGHT
UNITED STATES SENATE

April 20, 1982

Mr. Chairman and Members of the Subcommittee:

I welcome this opportunity to appear before your Subcommittee to discuss the characteristics of the Consumer Price Index (CPI) which is used to "index" a large--and growing--proportion of government expenditures.

Over the past twenty years, both the number and the size of the government programs subject to automatic escalation have increased dramatically. Given the rapid inflation of the past several years, it is not surprising that policymakers are increasingly concerned about the impact of automatic indexing on the size and controllability of government expenditures.

Because these issues are so important, I want to be sure that Members of the Congress understand exactly how BLS constructs the indexes used to escalate government payments. As Commissioner of Labor Statistics, I must leave the policy issues to those in the Administration and the Congress who have responsibility for policy determination. My role is to comment on the technical and conceptual questions involved in the measure used for escalation. These issues are of great concern to us at BLS and we want to do what we can to promote public understanding of them.

In general terms, the purpose of most indexation is to adjust payments in order to keep purchasing power constant. To achieve this objective, an accurate index is required. The CPI as the major economic indicator designed to measure changes in consumer prices has commonly been chosen as the primary indexing mechanism. The CPI is a good statistical measure, but,like any other statistical measure, the CPI is not perfect. In recent years, several questions concerning the methodology used to construct the CPI have been widely discussed. It is important that public policy decisions on indexation reflect a full understanding of these issues.

In discussing the use of the CPI as a tool for indexation, it is important to focus on two criteria for judging whether the CPI should be used in a particular escalation agreement. First, how well does the CPI achieve its stated objective of measuring changes in the cost--at market prices--of a representative market basket of goods and services? Second, how relevant is this objective for the particular escalation agreement? Today I will discuss one set of issues involving the use of a fixed market basket--which relates to the first criterion. I will then discuss several issues which relate to the second criterion, the applicability of the CPI as an indexation mechanism in many escalation agreements. Finally, I will briefly describe BLS plans for improving the CPI.

1. The Fixed Market Basket

The CPI is constructed by obtaining the prices, each month, of a set of goods and services purchased in the base period (currently 1972 and 1973). This market basket is based upon a survey of consumers conducted during these years. BLS practice has been to hold the weights for the mix of goods and services purchased during the base period constant until a major revision of the index occurs--about every 10-12 years. The market basket is kept constant deliberately in order to isolate price changes from changes which may occur in living standards.

In recent years, as prices have continued to climb, some people have argued that the CPI market basket does not adequately represent current experience. They contend that rational consumers shift their purchases in response to changes in relative prices, and suggest that the CPI might overestimate the cost of maintaining current living standards.

Historically, differences in weighting patterns have not usually created large differences in price index measures. BLS research suggests that between CPI revisions in the past, the effect of consumption shifts on price measurement has been no more than a tenth or so of an index point per year. Of course, past experience on this question may not be conclusive, especially in the most recent years when inflation has been running at double-digit rates, and large changes in certain prices (energy, for example) have been experienced.

Another way to gain perspective on the effect of weighting patterns on price index measurement is to examine the Commerce

Department's Deflator for Personal Consumption Expenditures, for this index is published in alternative versions with different weights. The two most relevant versions of the PCE Deflator for 1981 differ by only 0.1 percentage point. That is, the PCE Deflator using 1972 weights and the PCE Deflator using 1980 weights both record similar measures of inflation during 1981--9.1 and 9.0 percent, respectively. Those are two price indexes that differ from each other only in the weights, and I would emphasize that most of the detailed price data in the PCE indexes come from the CPI.

There are many differences between the PCE Deflators and the CPI, so comparisons of re-weighted PCE Deflators are only suggestive. However, the data I have seen on this issue suggest that the effect of weighting differences on the CPI measurement is probably considerably less than what it has been speculated to be in some parts of the press and academic circles.

But even if comparison of indexes with alternative weighting schemes indicates that use of a more current market basket would not have had as large an impact as some have suspected, it is important to recognize that this result need not continue in the future. The BLS for more than three decades has recognized the need for a continuing consumer expenditure survey. I am pleased that we have begun to conduct such a survey and can report to you that these data are now being compiled. When this survey has been fully set in place, BLS will be able to monitor the degree to which consumption patterns are changing and to have at hand the data required for future revisions of the CPI weights.

2. The CPI as an Aggregate Indexing Mechanism

The CPI, like any other index number, is essentially a statistical construct designed to answer a specific question. Unfortunately, the precise question is not often stated explicitly, and the same index can be construed or, in some cases, misconstrued as an answer to a number of alternative questions.

In recent years, three issues of price measurement have frequently been raised--the treatment of taxes, the treatment of import prices and the definition of the target population, and I would like to comment on each of them.

Taxes. The CPI includes only those taxes that are directly related to the purchase of the goods and services in the CPI market basket. Thus, sales, excise and other indirect taxes are included in the CPI. Income and other direct taxes are excluded. This treatment of taxes is consistent with the CPI focus on the expenditure necessary to purchase the market basket.

Although we would not like to treat taxes differently in an index which attempts to answer the question addressed by the current CPI, further research on the treatment of taxes in alternative indexes could be constructive. For example, if policymakers were to change the tax structure by moving away from direct taxes toward indirect taxes, such a tax shift would affect the CPI. Under these circumstances, the CPI could show an increase even though there has been no change in the overall tax bill.

The ultimate solution to this kind of issue is not to change the CPI but rather to understand the question to be answered by the index and, if an index with different tax treatment is desired, to construct one. An index which included all taxes, for example, would measure the income necessary to yield sufficient disposable income to purchase the CPI market basket. Under certain conditions, such an alternative might be appropriate as an escalator, but this can only be determined by the parties to the escalation agreement. One might argue for the index which includes all taxes since it focuses on before-tax income, which is the object of most escalation agreements. On the other hand, one might argue against such an approach if it is believed that the cost of tax increases is offset by changes in the value of public goods available to the consumer.

Construction of alternative indexes frequently present a number of difficult practical problems,but they may nevertheless be useful as a response to the increasingly complex uses to which the CPI is put.

Treatment of imports. Primarily since the drastic increase in the relative price of petroleum-based products, questions have also been raised about the treatment of imported goods in the CPI. It is sometimes argued that increases in imported prices should be factored out of the index because these increases are exogenous to the domestic economy. If the participants in an escalation agreement decide that they do not wish to compensate for increases in the price of imported goods, then they are deciding that, for their purposes, the CPI does not address the appropriate question. They may seek an index which nets out in some way the effect of increases in import prices. Such an index would be difficult to estimate with precision. Eliminating the direct expenditures by consumers on petroleum products is relatively easy to accomplish. Full estimation, however, would require assumptions about the structure of the economy and the role of imports in domestic production.

It should be emphasized, of course, that imports are part of consumption, and import prices belong in an index that measures living costs. The fact that parties to a particular indexation agreement might wish to exclude import prices does not mean that the CPI is in "error" in carrying out its purpose of measuring consumer prices.

Indexes for Particular Population Groups. Finally, it should be recognized that the rate of inflation can vary across households, and that the average may not represent the experience of any individual subgroup. In particular, differences among households may be related to such characteristics as age and income level. We do not know the extent of this variation or the degree to which it is systematic. For this reason, it is possible that use of an aggregate index for adjusting payments could result in all households being equally compensated for changes in living costs, whereas some households actually gain while others lose.

Even if we assume that all households experience the same change in average price level, it is possible that their need for indexation will depend on what happens to their income. The CPI measures the change in total expenditure necessary to purchase a set of goods and services. To the extent that the percentage of income provided by indexed programs varies among households, the degree to which households are insured against inflation by indexation will also vary. In other words, the change in a household's living standard as a result of inflation will depend on how all of its income sources vary with inflation. Thus, even in this very simplified case, living standards could change substantially despite escalation of benefits by an accurate index.

I raise these issues relating to the target population of an index because they pertain directly to recent suggestions that special indexes might be designed to index payments to subgroups of the population, such as the elderly. These issues are potentially just as important in designing an effective indexation program as those technical issues, like the use of a fixed market basket, which are important for all uses of the index.

We do not know whether an index for a particular group of the population would produce results that are very different from the CPI for All Urban Consumers. A whole series of important issues would have to be clarified before any empirical testing could even be done. For example, policymakers would have to prescribe the exact definition of the group to be represented, and new samples of market basket items, outlets and areas for price collection would have to be developed.

3. Future CPI Improvements

Homeownership. On October 27 of last year, I provided notice to users that the Bureau of Labor Statistics will change the homeownership component of the Consumer Price Index to a rental equivalence measure. I have here a detailed statement of the reasons for this decision and the specific steps that will be taken which I would like to submit for the record. In summary, the major points of the decision are:

* Effective with data for January 1983, the homeownership component of the official CPI-U will be changed to a rental equivalence measure and

* Effective with data for January 1985, the CPI-W will be revised to a rental equivalence measure

* The new homeownership components will be linked into each CPI at the end of the year preceding the change, i.e., December 1982 for the CPI-U and December 1984 for the CPI-W, in a technical manner similar to that which has been used in previous major revisions of the CPI

* The Bureau will continue its efforts to improve the rental equivalence measure through refinements in procedures and calculation methods and eventually through supplementation of the rent sample.

Comprehensive Revision of the CPI. The last topic I would like to discuss is the next comprehensive revision of the CPI. Some time ago, the Bureau staff began the planning for this project. During the next revision of the CPI, we believe that several major improvements should be made. Among the most important are:

* First, the market basket for the CPI should be updated to reflect changes in consumer spending that have taken place since the 1972-73 period currently used as the reference base.

- Second, the results of the 1980 Census of Population should be incorporated in the index to account for the population shifts that have taken place since 1970.
- Third, the rental equivalence sample to be used to measure homeowners' shelter costs should be further expanded and improved.
- Fourth, a schedule for systematic replenishment of price reporter samples should be established for those components of the CPI that currently are not on one.
- Finally, the CPI computer system should be modernized, data collection techniques should reflect more current state of the art technology, and additional research on index measurement issues should be undertaken.

Mr. Chairman, thank you for inviting me to testify today. I would be pleased to answer any questions which you or the Subcommittee members might have.

News
United States
Department
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USDL 81-506
FOR RELEASE: 10:00 A.M. (E.S.T.)
Tuesday, October 27, 1981

STATEMENT OF DR. JANET L. NORWOOD COMMISSIONER OF LABOR STATISTICS REGARDING CHANGES IN THE CONSUMER PRICE INDEX

I am today providing public notice to all users of the Consumer Price Index that the Bureau of Labor Statistics plans to change the homeownership component of the index to a rental equivalence measure. The Consumer Price Index for All Urban Consumers (CPI-U) will be changed with publication of data for January 1983; the Consumer Price Index for Wage Earners and Clerical Workers (CPI-W) will be changed with data for January 1985.

The treatment of owner-occupied housing in the Consumer Price Index has been one of the most widely-discussed issues in economic statistics in recent years. The Bureau of Labor Statistics first called attention to the issue 10 years ago, and, since then, has encouraged public review of alternative approaches to the current treatment while working on a program to improve this component of the CPI. Normally, this work would be concluded as a part of the next revision of the index which, in a usual budget atmosphere, would be planned for implementation beginning 1985 or 1986. However, a number of things which have occurred during the past year require that the time schedule for improving the housing component of the CPI be shortened.

Background

Important changes have occurred in financial markets. The CPI does not reflect these changes. First, funds available for long-term mortgage commitments have declined sharply. New types of mortgage instruments involving variable rates, shorter financing terms, and other special arrangements have developed so that the standard long-term fixed rate mortgage used in the CPI no longer seems representative of the mortgage market. In fact, some of the new instruments have characteristics, such as variable rates and principal amounts, which make it impossible to use them in computing the CPI since it reflects a long-term mortgage at fixed interest rates. Secondly, because of high interest rates and difficulties faced by home buyers in securing bank mortgages, owners who wish to sell their homes are increasingly doing so by providing financing to buyers at rates below those of lending institutions. These kinds of financing arrangements are not captured at all in the CPI data collection process (see Exhibit 1).

The Bureau of Labor Statistics obtains data on house prices from the Federal Housing Administration. This data base, which represents a relatively small and specialized segment of the housing market, continues to present BLS with increasingly serious estimation problems. BLS has had only very limited success in developing alternative sources of house price data.

The Economic Recovery Tax Act of 1981 (Public Law 97-34) requires use of the CPI for All Urban Consumers (CPI-U) for escalation of income tax brackets and the personal exemption amount. The law requires announcement of the new tax brackets in December 1984 based on CPI-U data in the 2 prior years. This is a major new use of the index, a use which will have a broad effect on total Federal Government revenues. A Senate Finance Committee report has estimated that the decrease in Federal revenues as a result of indexation will amount to nearly $13 billion. In my view, this new use of the index underscores the importance of action to ensure that we have a CPI which reflects the experience of consumers to the fullest extent possible.

Increasingly, Members of Congress, the media, and the general public are becoming aware of the issues surrounding the measurement of homeownership costs in the CPI. A growing number of people feel that there is something wrong with the CPI and that it should be fixed. In light of the extensive use of the CPI in our economic system, it is essential that public confidence in it be maintained.

Action Planned

These facts clearly indicate that the time for changing the CPI has come. At the same time, BLS recognizes that it has an obligation to all users to provide substantial advance notice of a major change in the concept and calculation procedure of any important component of the index. I have decided on the following actions:

1. Effective with data for January 1983, the homeownership component of the official CPI-U will be a rental equivalence measure, like the present CPI-U-X1 experimental measure, but with some refinements.
2. Effective with data for January 1985, the CPI-W will be revised to a rental equivalence measure.
3. The new homeownership component will be linked into each CPI at the end of the year preceding the change, i.e., December 1982 for the CPI-U and December 1984 for the CPI-W, in a technical manner similar to that which has been used in previous major revisions of the CPI. In accordance with historical practice, BLS will make available to users after the change in the official indexes calculations based on the current treatment of homeownership for a 6-month overlap period. In the case of the CPI-U, the overlap period will run from January to June 1983; for the CPI-W, the overlap will run from January to June 1985.
4. The Bureau will continue its efforts to improve the rental equivalence measure through refinements in procedures and calculation methods and eventually through supplementation of the rent sample.
5. BLS will cease monthly publication of the CPI experimental alternative homeownership measures at the time the change is made in the official CPI-U.
6. In the interim period, until the CPI-U is officially changed, BLS will give greater prominence to analysis of the CPI-U-X1 in the narrative portion of the CPI press release.

See Exhibit 2 for schedule.

Timing of Changes

There is work currently underway at BLS to improve the method of calculating the rental equivalence measure now used in the CPI-U-X1. This work, which we expect to complete in the latter part of 1982, will improve the accuracy of the rental equivalence measure and provide for its regular calculation within the main CPI processing system. The time required to do this work, the shorter history of the CPI-U, its special uses, together with the requirement for pre-notification of users of major CPI changes, determined the schedule for changing the CPI-U.

The CPI-W is used extensively in escalation agreements in both the private and public sectors, considerably more than is the CPI-U. Some major collective bargaining agreements which use the CPI-W run for as long as 3 years and specify that the parties to the agreements would, in the event the Bureau changed the CPI-W materially, request the BLS to continue to supply the index as it was calculated when the contract was made. In the light of such arrangements and the background of historical practice relating to the CPI-W, I believe that users must be publicly notified substantially in advance of changes planned for the CPI-W so that they have adequate time to adjust to the changes.

Exhibit 1

CPI HOMEOWNERSHIP COMPONENT

	Current Treatment	Rental Equivalence
1. Concept:	Purchase of asset	Purchase of shelter
2. Families covered:	For house price and mortgage interest only those families who in base period purchased house	All families who lived in owned homes during base period; covers the entire stock of owned homes
3. Method of weight derivation:	a) For property taxes, property insurance, home maintenance and repairs: expenditures of all homeowners in base period b) For house price: Total price of house only for those who purchased in base period c) For mortgage interest: Total amount of interest expected to be paid over half the stated life of the mortgage only for those who purchased house in base period	Estimate of rental value of all owner-occupied houses in base period; based on specific question asked in Consumer Expenditure Survey
4. Prices used:	Current monthly prices for each element, including current price of house and current mortgage interest rate (Conventional, FHA and VA)	Current rent paid for homes like those that are owned

Exhibit 2

MAJOR DATES IN CPI CHANGE

January 1982	Publication of CPI for December 1981 - increased prominence for CPI-U, X1 in the text of CPI press release
1982	Work on enhancement of CPI-U, X1 rental equivalence measure
February 1983	Publication of CPI for January 1983 - first publication of CPI-U with rental equivalence homeownership - last publication of CPI experimental measures
July 1983	Publication of CPI for June 1983 - last publication of overlap CPI-U with current homeownership methods
1984	Publication of rental equivalence homeownership with expanded rent sample and improved computation methods
February 1985	Publication of CPI for January 1985 - first publication of CPI-W with rental equivalence homeownership
July 1985	Publication of CPI for June 1985 - last publication of overlap CPI-W with current homeownership method

PREPARED STATEMENT OF ALICE M. RIVLIN

Mr. Chairman, reductions in cost-of-living adjustments (COLAs) for federal entitlement programs have figured prominently in discussions of efforts to reduce projected federal budget deficits. The reason is clear: the budget costs associated with COLA adjustments are huge. COLA adjustments for fiscal years 1982 through 1985, for example, will cost about $112 billion.

Besides the implications of COLA changes aimed at immediate relief of our budget problems, a lot of attention has been devoted to longer-run reforms of federal COLA procedures. My testimony today will focus attention on two prominent reform proposals:

- the replacement of the current measure of homeownership costs in the Consumer Price Index (CPI) with a measure that more accurately reflects the price of housing services; and
- the construction of a special consumer price index for the elderly as the basis for making COLA adjustments for federal entitlement programs.

My statement will make three major points:

First, the current CPI is a flawed measure of the cost of living largely because the homeownership component is a poor measure of the price of housing services. Replacing the current measure of homeownership costs with a rental equivalence measure would provide us with a better measure of the price of housing services. The decision to replace the current homeownership component in the CPI with a rental equivalence index should provide us with a superior measure of the cost of living.

Second, replacement of the current CPI with a revised rental equivalence CPI as the COLA index for federal entitlement programs, although justifiable on conceptual grounds, would not necessarily result in any net budget savings. The rate of inflation measured by the revised index could be higher or lower than the rate measured by the current CPI depending on prospective changes in house prices, house rents, and mortgage interest rates. Indeed, there is considerable likelihood that the revised CPI could exhibit more inflation than the current CPI for the next year or so at least. Accordingly, proposals aimed at pushing forward from 1985 to 1983 the date at which federal entitlement programs are scheduled to be indexed to the revised CPI could result in budget losses, not budget savings.

Third, there is little hard evidence to support the view that the CPI misrepresents the cost of living for the elderly. The data, imperfect though they are, suggest that differences between the economy-wide CPI and a special index for the elderly would have been small for the 1970s. Alternative treatments of the cost of homeownership would not have affected this result materially.

The CPI as a Cost-of-Living Measure

Criticism of the current CPI centers on its treatment of homeownership costs. Ideally, a cost-of-living measure should include only the actual costs people incur in meeting their shelter needs. One approximate measure of the shelter cost of a home is its rental value: when people pay rent for a home, they have "nothing to show for it" at the end; each month's rent simply pays for the services consumed currently. The current CPI measures more than the shelter cost of the home to the homeowner. Included in the current CPI market basket is the purchase price of the home, an estimate of its financing costs, taxes and insurance, and the cost of house maintenance. In return for these costs, homeowners get more than just places to live. They get an investment with special advantages as a tax shelter and as a hedge against inflation; they frequently have "something to show" for the money they have spent. To include the investment value of homeownership in a cost-of-living measure is a distortion. We do not include the costs of stocks and bonds that people buy in the CPI measure of their cost of living; neither should we include the investment value of homeownership.

In an effort to obtain a truer measure of the cost of shelter services, the Bureau of Labor Statistics (BLS) has announced that it intends to replace the current treatment of homeownership costs in the CPI with a rental equivalency measure--in effect, BLS will replace the current homeownership component with a rent index based on a sample of dwellings that is, as nearly as possible, representative of the types of homes occupied by owners. The revised treatment is to be implemented for the CPI-U in 1983; the CPI-W, the index currently used for Social Security COLAs, is scheduled for revision beginning in 1985.

Although the revised treatment of homeownership costs presents difficult measurement problems, the conceptual attractiveness of the rental equivalency approach is widely acknowledged. The inclusion of only the shelter services of a home reduces the total relative importance of homeownership costs from about 31 percent in the current CPI to about 21 percent in the revised CPI. This 10 percentage-point reduction in weight is a measure of the investment value of homeownership that is inappropriately referred to as a component of the cost of living in the current CPI. The reduced weight means that the revised index will be considerably less sensitive to housing market developments than the current CPI.

The Effects of the Revision in Homeownership Costs on the Measurement of Inflation and the Budget

Substitution of a rental equivalency measure for the current treatment of homeownership costs would have made a substantial difference to the behavior of the CPI over the past decade. BLS has produced an experimental index (CPI-U-X1) based on the rental equivalency notion extending back to 1967. To the extent that the cost of homeownership embodied in that experimental index accurately measures the cost of the shelter services of a home, the official CPI overstated the actual rate of inflation by 0.7 percentage points per year on average since 1967 (see Figure 1).

The main determinants of the differences between the CPI and the experimental indexes are documented in Figure 2.

FIGURE 1.

CPIU vs. CPIU-XI
(December Data, 1973 = 1.0)

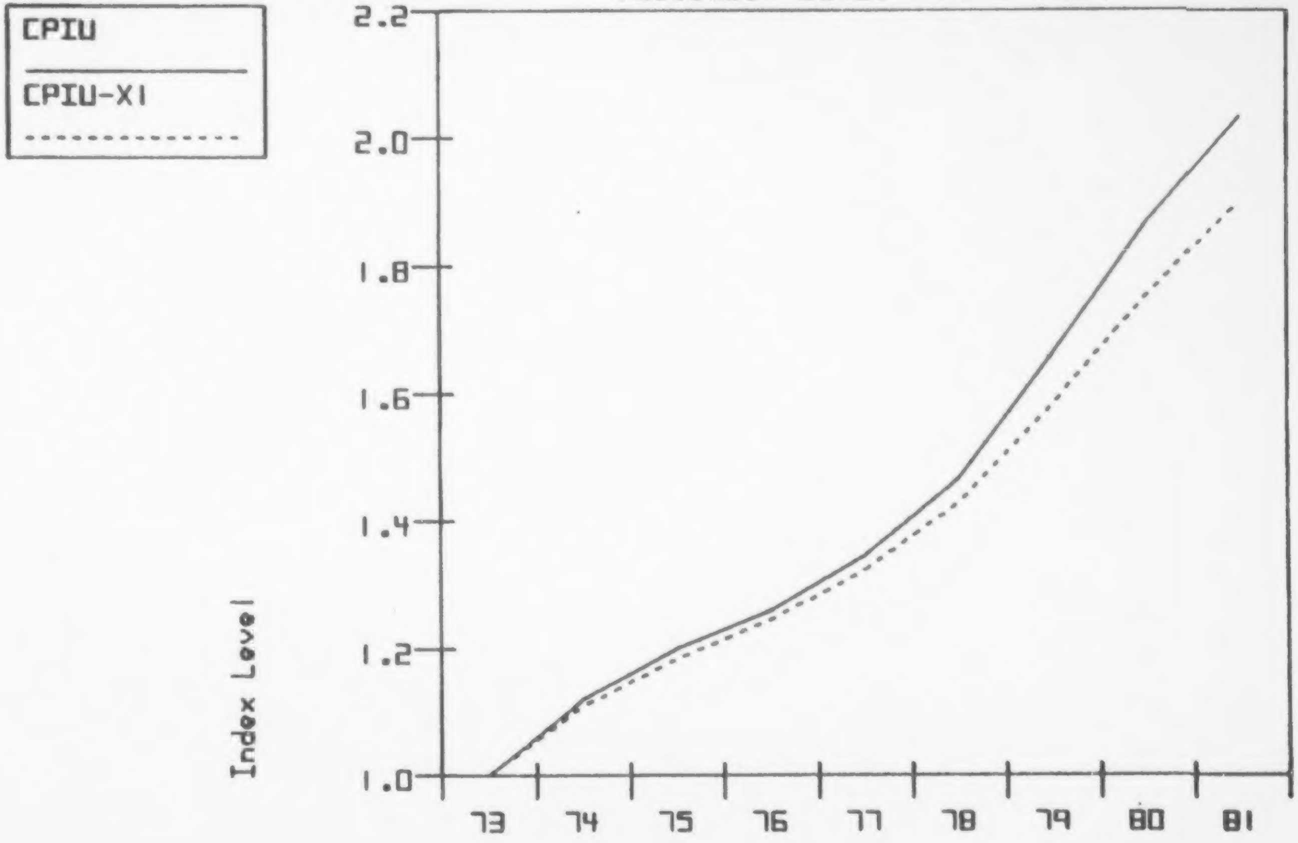
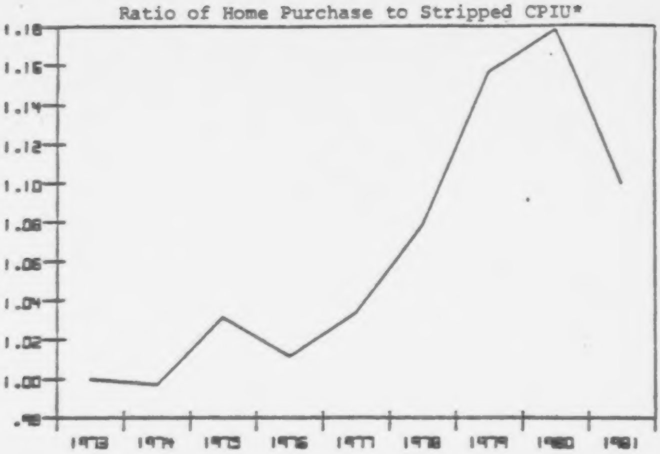
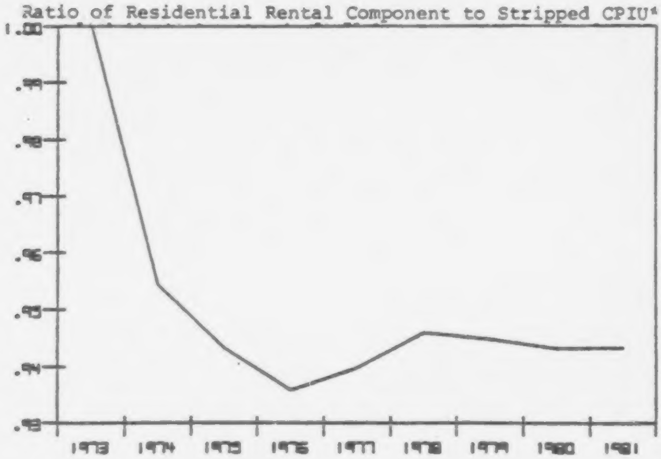


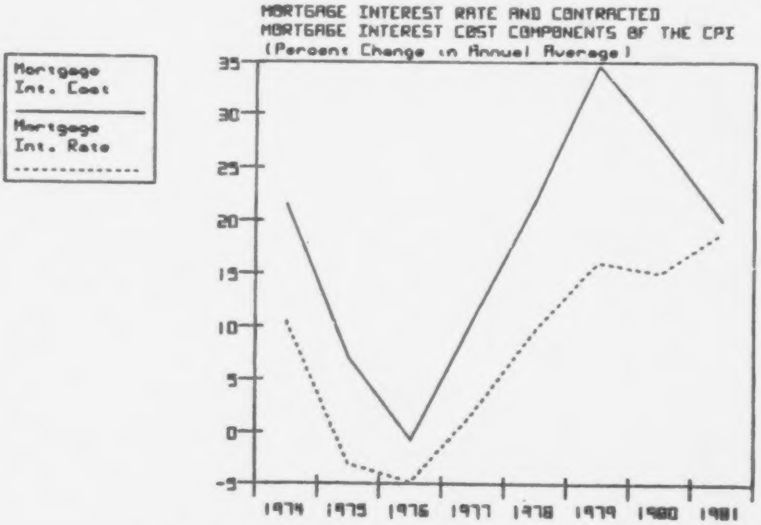
FIGURE 2.



Ratio of Home Purchase to Stripped CPIU*



Ratio of Residential Rental Component to Stripped CPIU*



MORTGAGE INTEREST RATE AND CONTRACTED MORTGAGE INTEREST COST COMPONENTS OF THE CPI (Percent Change in Annual Average)

*CPIU less food at home, energy, homeownership, and used cars.

- Over the decade, house prices rose by almost 20 percent more than the prices of other goods and services.
- Over the course of the 1970s, rents rose by 10 percent less than the average of other prices.
- Over the same period, mortgage rates rose dramatically, from the neighborhood of 8 percent at the beginning of the decade to rates of about 16 percent at the end.

Higher mortgage rates and higher house prices tended to increase the current CPI but had no direct impact on the experimental index. Lower rents reduced the experimental index by more than they did the current CPI. All these factors led to a growing gap during the 1970s and early 1980s between the two indexes.

The budgetary impact of this apparent overstatement of inflation has been substantial. A difference of one percentage point in the CPI can increase or decrease outlays on indexed federal entitlement programs by about $2 billion. The cumulative discrepancy between the CPI and the experimental index since Social Security indexing was started amounted to about 5.8 percent at the beginning of 1981: this means that Social Security payments are now over $6 billion per year higher than they would have been if the rental equivalency measure had been used for adjusting benefits since 1974. Counting all entitlement programs, the annual excess cost of the overstatement of inflation since 1974 approaches $8-1/2 billion.

Although the trend differences between the CPI and the experimental index have been sustained for an extended period of time, it would not be appropriate to extrapolate those differences into the future. Indeed, many people think that the revised CPI will exhibit more inflation than the current CPI for the next year or two at least. Beyond that time frame, however, it is impossible to determine whether the revised CPI will show more or less inflation than would have been shown by the current CPI.

The relative prospective rates of inflation as measured by the current CPI and the revised CPI will be determined almost exclusively by the prospective rates of increase of three price components--mortgage rates, house prices, and rents. While some of the past trends in these components are likely to continue into the 1980s, with possible interruption during the current recession and subsequent recovery, others are likely to be reversed.

- Mortgage rates are not expected to continue rising as they did in the 1970s and early 1980s. The only basis for continuing long-run increases in mortgage rates would be an accelerating rate of inflation. However, almost every forecast, including that of CBO, projects lower rates of inflation in the future.
- The recent softness in house prices could persist for some time into the future aided, in part, by a continued slump in the housing market. However, because the demographic factors underlying housing demand will remain strong through the mid-1980s at least, house prices are likely to continue to increase faster than other prices during the decade of the 1980s.
- It is very uncertain at this time whether future rents will rise or fall relative to the prices of other goods and services. In any event, there is no reason to anticipate further persistent declines in rents relative to house prices.

Other things remaining equal, if mortgage rates fall this will lower the growth of the current CPI relative to the revised index; if house prices rise faster than those of other goods, the current CPI will tend to grow faster than the revised index; and given the greater weight of the rent index in the revised CPI, an increased pace of rental prices would raise the growth of the revised index relative to the current CPI.

A great many factors will affect future movements in mortgage rates, house prices, and rents; these are analyzed in the Appendix. Taking them together, there is considerable likelihood that declining mortgage rates would pull the growth of the current CPI below that of the revised index in the next year or two. Beyond that period, CBO's best guess is that inflation rates calculated using the current measure of homeownership and the rental equivalence measure will not differ from one another substantially.

Is There Need for a Special Consumer Price Index for the Elderly?

A lot of interest has centered around the idea of a special consumer price index for the elderly to be used as the basis for determining the size of COLA adjustments for federal entitlement programs. Two important issues have been raised by this discussion:

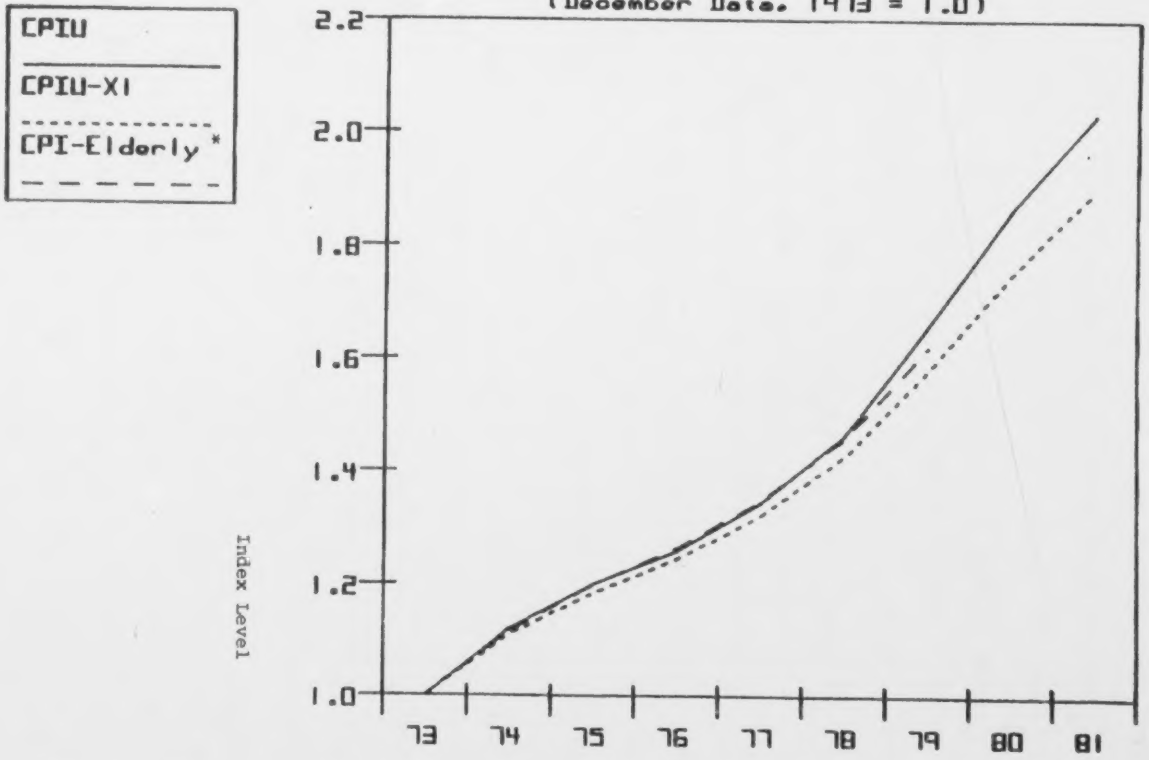
- The first is conceptual: would it be appropriate to use a special consumer price index for the elderly as the basis for making COLA adjustments for federal entitlement programs?
- The second is factual: to what extent does the economywide CPI misrepresent the degree of inflation experienced by the elderly?

Although the case for a special index for the elderly is attractive conceptually, two considerations need to be kept in mind. First, federal entitlement programs provide benefits to more than just the aged. The elderly are admittedly the largest subgroup of recipients, but as of November 1981, almost one-third of all Social Security beneficiaries were under the age of 65; almost one-fourth were under the age of 62. Second, because spending patterns vary so widely among the elderly--reflecting, in part, the marked differences in economic circumstances faced by the aged--it is not clear that a special measure of the cost-of-living change experienced by the elderly would be much better than the current CPI.

This brings us to the second issue--the degree to which the economywide CPI misrepresents the extent of inflation experienced by the elderly. We know that the elderly, on average, spend a greater proportion of their income on food at home and on medical care, though inadequate account has been taken of the complex medical insurance situations facing the aged; we know that the elderly spend a lower proportion of their income on food away from home, on transporation, and on recreation; and we know that they are more likely to own their homes outright. Despite these spending pattern differences, the evidence, imperfect though it is, suggests that differences between the economywide CPI and a special index for the elderly would have been very small for the decade of the 1970s. Consumer price indexes incorporating expenditure weights more appropriate to the elderly population tend to move in a manner very similar to the movement of the economywide CPI (see Figure 3). Importantly, the differences between these two indexes are not particularly sensitive to changes in the treatment of homeownership costs. This meets directly an often repeated criticism that movements in the cost of homeownership as measured in the

FIGURE 3.

CPIU, CPIU-XI, and CPI-Elderly
(December Data, 1973 = 1.0)



*Source: "Indexing of Social Security Benefits", A. DiPietro and B. Smith, U.S. Treasury Study Paper, September 1980. Index uses rental equivalence measure of homeownership.

current CPI are of little relevance to groups such as retirees, since the freqeuncy with which they purchase houses is much less than for urban consumers in general. Thus, although the revised index will more accurately reflect the expenditure patterns of the elderly, the rate of inflation for the elderly is little affected.

To represent even better the expenditure patterns of the elderly and other recipients of entitlement program outlays, a case can be made, on conceptual grounds at least, for replacing the CPI-W, the current COLA index, with the CPI-U. This is because the CPI-W is based on the expenditure patterns of urban wage and clerical workers only, whereas the CPI-U is based on the expenditure patterns of all urban consumers, including retirees.

Conclusion

In conclusion, Mr. Chairman, the present Consumer Price Index is not a satisfactory measure of the cost of living because it does not accurately treat homeownership costs. While this deficiency will be corrected in the new, revised CPI, we cannot be certain whether the change will increase or decrease the cost of indexed federal programs over the long run in comparison to their costs using the present CPI. Finally, although the idea of switching to a special index for the elderly as the basis for COLA adjustments for federal entitlement programs is conceptually attractive, it requires more study before being pursued.

APPENDIX. FACTORS INFLUENCING FUTURE MOVEMENTS OF HOUSE PRICES, RENTS, AND MORTGAGE INTEREST RATES

Future Movements in House Prices

Prediction of house prices requires balancing underlying demographics against variations in financing costs, current house prices, and the expected returns from owning houses. The expected returns are themselves sensitive both to expected house price changes and to changes in tax laws.

- The demographic pressures on house prices that were partly responsible for the rapid escalation of those prices in the 1970s are still present. In the outyears, however, all indications are that the demographic pressures will ease substantially. This points to continued upward pressure on house prices in the near term followed by considerable easing later on.

- The current slump in the housing industry means that the housing stock in the near term will be unusually low. For any given increase in demand for housing in the next few years, house prices are therefore likely to increase more rapidly than otherwise. What the future holds in this regard is very uncertain.

- Over the near term, prospective reductions in mortgage rates are likely to stimulate a significant increase in the demand for housing, both because of reduced financing costs generally and because lower mortgage payments increase the size of the pool of qualifed buyers. However, the rapid escalation of house prices over the course of the past decade has increasingly put homeownership out of reach of large numbers of families. How much demand for housing will increase in the short run is, therefore, uncertain. There is even more uncertainty with respect to the long term.

- If the overall inflation rate falls as many forecasters now predict, the incentive to use real estate as an inflation hedge will be reduced, easing the upward pressure on house prices. Lower inflation will also reduce the tax advantages for homeowners, in particular the favorable tax treatment of capital gains derived from house sales. The reduction in the overall inflation rate may ease the upward pressure on house prices.

- Current house prices may contain a premium representing the costs of "creative financing." Lower interest rates could conceivably reduce house prices below what they would otherwise have been.

- If the new variable-rate mortgages prevent unexpected reductions in real mortgage rates whenever the rate of inflation is unexpectedly high, then real mortgage rates could be higher in the 1980s than in the 1970s--though presumably not higher than their recent historical peaks. This would help slow the demand for housing and slow the rate of housing price increases.

Thus, there are plausible reasons to expect either an acceleration or a deceleration of housing prices.

Future Movements in Rents

It is extremely difficult to predict future trends in rents. Rents and house prices are related to one another, but the relationship is a complex one. Some argue that when house prices are expected to increase, landlords may figure more capital gains into their rate-of-return calculations and temporarily hold down rent increases. Others argue that since house prices must ultimately correspond to the capitalized value of the stream of rents, expected house price increases will ultimately raise rents. There are other uncertainties as well:

- The new rent index to be used in the revised CPI will not be identical to the rent index in the current CPI. The revised rent sample for owner-occupied housing may well show faster growth in rents than the current one. The current rent sample contains a disproportionate number of inner-city housing units that have fallen into disrepair over time. This may have been due, in part, to the existence of rent controls, which served to slow the rate of rent increases relative to other prices. Rent controls have no meaning in the context of owner-occupied housing, and owner-occupied housing is generally maintained in much better repair than rental housing units, implying correspondingly higher rental equivalence values.

- The rate of increase in rents may also be affected by general housing market developments. If lower inflation rates, higher real mortgage rates, and reduced tax advantages from owner-occupied housing slow the demand for housing, this would increase the demand for rental units, increasing the rate of rent inflation. On the other hand, provisions of the Economic Recovery Tax Act of 1981 that make it possible to depreciate rental property on a greatly accelerated schedule will increase incentives to invest in rental housing. This increase in the supply of rental housing would tend to hold down rent increases.

- The house price index used in the current CPI is based on the prices of houses backed by FHA mortgage guarantees. The rate of increase in this price index has been less rapid than the rate of increase in housing prices generally, according to census data. The rental equivalency measure for all owner-occupied housing, therefore, could show more inflation not only relative to the current rent index, but relative to the current house price index.

- Rent controls affect the CPI measure of rents to an unknown extent. If rent controls became more prevalent, this would reduce the CPI measure of the rental equivalent value of owner-occupied housing relative to its value in the free market.

Future Movements in Mortgage Rates

Almost all forecasters agree that mortgage rates will decline from their current record high levels over the near term, both because the inflation rate is expected to decline and because some reduction in real mortgage rates is anticipated.

We cannot be confident, however, that mortgage rates will decline significantly after 1983. If mortgage rates fall sharply in 1982, then, other things being equal, the current CPI will fall relative to the CPI-U-X1 in 1982. But unless mortgage rates continue to fall through 1983, the decline in mortgage rates will not affect the old CPI measure in 1983 and beyond, and consequently the CPI revision will not have any important impact on measured inflation rates from 1983 onward. It is not possible at present to make meaningful predictions as to whether mortgage rates will be rising or falling between 1983 and 1985, or from 1985 onward.

Senator MATTINGLY. Our next witness is Geoffrey Moore, a former Commissioner of Labor Statistics and now director of the Center of International Business Cycle Research.

Dr. Moore is also affiliated with the American Enterprise Institute.

Welcome, Dr. Moore.

Mr. MOORE. Thank you, Mr. Chairman.

Senator MATTINGLY. If you would like to summarize your statement, or however you would like to do.

TESTIMONY OF GEOFFREY H. MOORE, DIRECTOR, CENTER FOR INTERNATIONAL BUSINESS CYCLE RESEARCH, NEWARK, N.J.

Mr. MOORE. I have prepared a statement I would like to have in the record, but let me summarize it for you.

I would like to address myself first to the question which has really not been discussed broadly, how to calculate the rate of inflation in the Consumer Price Index for escalation purposes.

As you know, the present method used for social security is to compare the first quarter's index, the average value of the CPI for the first quarter of this year, with its average value in the first quarter of last year. This is a same quarter a year ago-type comparison. And that change gets put into effect in the July adjustments of social security benefits.

There are alternative ways of calculating that rate of increase and I would like to propose one in particular that I think has greater merit to it. The method I am suggesting is that instead of comparing the first quarter's average CPI with the same quarter 1 year ago, compare it with the average value of the CPI during the preceding four quarters, that is the calendar year preceding the first quarter of this year.

That method has several advantages. One of them is that by using a whole year for the base, to compare with the first quarter average, you have a more stable value. It covers a longer period. If there are any particular things that happened in the first quarter a year ago that affected the CPI, it is likely to get ironed out over the course of the year, so comparing the first quarter of this year with the annual average for the preceding calendar year, gives you a more stable rate.

It is also a little more up to date than the comparison with the first quarter 1 year ago because the average that you are comparing it with for the calendar year includes the first quarter 1 year ago but also includes three quarters subsequent to that, so that the interval over which we are measuring inflation is shorter under this new formula.

That means that the rate of inflation that is represented by this measure is more up to date. It is more representative of the inflation rate that is currently being experienced by the people and, hence, is more relevant to the problem of escalating their income for next year.

One of the effects of using the new measure and substituting for the present measure is that when inflation is declining, as it is now, as you mentioned, Mr. Chairman, this type of measure is likely to give a lower rate of increase, which is closer to the actual rate that is being experienced currently.

On the other hand, when inflation is accelerating, as it has for many years, this measure is likely to give a higher rate at those times. What that means, I think, is that the new measure I am proposing would help people to keep up with inflation when it is accelerating and get them up to the current level of inflation, the actual level they are experiencing more rapidly.

On the other hand, when inflation is declining, as it is now, it will help to keep that rate on a declining basis because it will be putting less income based on earlier inflation rates into their current income.

Now, to show the result of that this year, I have made a rough calculation using the February Consumer Price Index instead of the average for the first quarter.

The March figure has not yet been released so I don't have that average, but using the February CPI as an estimate of what that quarterly average will be, my suggested measure gives an increase of 6.3 percent at annual rate as compared with 7.5 percent using the present official measure, comparing February with the first quarter 1 year ago.

The effect of that on the outlays for social security in the budget, I think, would come to a little less than $2 billion. That is, the difference of 1.2 percentage points would have roughly that effect on the outlays of social security payments. That, of course, puts less money in the pockets of the social security recipients but also takes less money out of the Federal budget. And I think myself that it would be justified partly for the reasons you were discussing with the previous witnesses about the possible overcompensation in previous years, but also because I really believe that an up-to-date measure of the rate of inflation is simply a better way to escalate benefits.

If you are going to change to a different method that is more up to date, you have to do it sometime. I think right now is a good time to do it for these several reasons.

That is basically the proposal I would like to put before you. Let me make one or two other observations about it. One is that this type of measure could be calculated monthly, using monthly data, rather than quarterly averages. And there are some benefits to be had from that. For example, when we have the March CPI, which I believe will be available Friday, we can use the percentage increase that that shows, compared with the average CPI over the preceding 12 months, the 12 months ending in February.

I don't know what that rate of increase will be, but it will be certainly more up to date than using the first quarter because March is a little more up to date than the first quarter average.

If instead of the March figure the escalation of social security payments could be based on the April index and still be put into effect in July, that comparison, comparing the April index with the average of the preceding 12 months ending in March, would be still more up to date and still closer to the period during which the effect of this on income will be felt by beneficiaries.

So I think something can be said for doing this with monthly data instead of quarterly data and get even more of the benefits that I mentioned before; namely, a more up-to-date comparison and still using an annual average as the base from which to make a calculation of the rate of increase.

Then I think this method can be used not only for social security benefits but for other escalated Government programs. It would certainly be relevant to Government pensions. It might be used to escalate the tax brackets for the income tax and other programs that require a rate of increase calculated in one way or another.

It can also be used to calculate the rate of increase in wages or earnings. One of the proposals that has been offered in various places is that escalation of social security be based on an alternative, either the rate of increase in earnings or the rate of increase in the consumer price index, whichever is lower. Well, both rates could be calculated in the same manner, either using quarterly data or monthly data.

In general, then, this is an approach to measuring the rate of inflation that can be applied to any index whether it is the CPI as it is now or the CPI with a rental equivalent method that was discussed earlier.

I would like, Mr. Chairman, to take just a few minutes to summarize my views on the index problem that was discussed earlier, namely this rental equivalent method.

I regard it as an improvement over the present method. I don't think it is quite right to say it corrects an error that the present method contains. There are various ways of measuring the cost of housing and the one that has been used for many years, used when I was Commissioner and before that as well, does take into account the cost of buying a house. People who want to live in their own homes do buy those houses. It does take into account what they have to pay on mortgage interest when they make that commitment. Consequently it is a measure of housing costs to those individuals who are in the market at the time.

It does not measure directly the cost to people who have already bought their houses. Those costs entered into the CPI at some earlier date when they engaged in that transaction and under the current method they are not in that measure now. So that does seem to me a reasonable alternative and was used for many years.

The rental equivalent method is another reasonable alternative. It does require, however, estimating what the equivalent rental that a homeowner would have to pay to occupy the house he owns. That, in some degree, is a conjectural measure. We don't know what the homeowner would actually have to pay to rent the house that he owns since he is not doing it. Some estimate has to be made of that and that is a drawback in a price index.

Anybody that has to make an estimate of that sort is up against a problem of computing something that hasn't really happened and attributing it to people who haven't experienced it.

So while I agree the rental equivalence method is a good measure to adopt it does not necessarily correct an error. It is simply a different method and, I believe, a better method to be used but not necessarily a more accurate one.

I do feel that it would be important to change both the CPI-U—that is for all urban consumers—and CPI-W for wage earners and clerical workers—at the same time and preferably earlier rather than later, that is, in January 1983. I do not believe it is a good idea to have two indexes for two different groups in the population, both of them very large indeed, with one index computed one way for 2 years, from 1983 to 1985, and the other index computed a different way. Those differences have nothing to do with the differences between the two groups. It is simply a difference in methodology that is applied to one and not to the other and I would much prefer to see both indexes changed in January 1983.

I think also that it might well be considered in legislation that the present rental equivalent index, the experimental one, might be used immediately. It's been calculated now for several years. We know its history back to 1967. Why not begin using it now? When the BLS recomputes the index with its new methodology, shift to that method at that time. If we want to get the benefits of the new method, I don't see any reason why that index shouldn't be used now. It is, in fact, a fairly good time to do it because both the official index and the experimental rental equivalent index are showing almost exactly the same rates of inflation now for the first time in several years.

So shifting from one to the other doesn't create a big problem of changing the rate of inflation depending on which one you adopt. That doesn't mean they won't show differences in the future, as the previous witnesses discussed, but right now they are virtually showing the same thing.

So I would suggest that change be made currently and that my suggested method of measuring the rate of inflation be applied to it and used in the escalation programs.

Thank you very much.

Senator MATTINGLY. Thank you, Dr. Moore.

I appreciate your comments, especially how to get it accomplished more expeditiously. You do agree, because of the incorrect means of calculating inflation, that the indexed programs have really been overcompensated—all the indexed programs.

Mr. MOORE. They have been overcompensated relative to the alternative method of measuring the rate of inflation, and since there seems to be general agreement that did overcompensate, I guess we have to agree to it. I do not agree the previous method was an error on the part of BLS. It was justified, I believe, by the evidence and advice that the BLS had at the time it adopted it many years ago and I think it was justified on that basis.

Senator MATTINGLY. You made a comment that you felt like the changes need to be made immediately. Let me ask you this question: You also mention that it be done legislatively. You being a former Commissioner of BLS, what can you do to make the change, doing it legislatively? Can the Commissioner of the Bureau of Labor Statistics make that change that you were talking about?

Mr. MOORE. The Bureau of Labor Statistics can simply provide the data that are called for in the legislation. My view is that it is already providing those data because it does calculate this experimental index based on the rental equivalent concept and it or anybody else can calculate the rate of inflation from it. All that is required is that the Congress specify which index that they are publishing is to be used and how the rate of inflation is to be calculated for this specific purpose. That seems to me to be a congressional matter.

Senator **Mattingly**. You say that should be done legislatively?

Mr. **Moore**. Yes.

Senator **Mattingly**. And not by the Bureau of Labor Statistics?

Mr. **Moore**. I think the BLS can simply provide the calculations.

Senator **Mattingly**. The changes that must be made need be applied to all the indexed programs, wouldn't you agree?

Mr. **Moore**. I am not familiar with all of them, so I am a little hesitant to say all. It does seem to me wherever what is involved is an escalation of an income or pension or benefit, then it should be applied there. I am not sure whether that includes everything.

Senator **Mattingly**. In conclusion, I would like you to elaborate on one comment you made that now is the best time to change. Is that because we are in a period of deflation?

Mr. **Moore**. I think now is the best time to change because I am not able to forecast that there will be a better time. I do think that the rental equivalent index is showing virtually the same rate of inflation as the official index at the present time and that makes it a good time to change.

With respect to changing to my method of calculating the rate of change, it is an appropriate time because it will currently yield a lower rate that is closer to the rate that is now being experienced by the population. It will help to keep that rate low and declining by providing less income and a more appropriate level of income, in view of inflation, to the population instead of a larger figure. That will extend and support the decline that is already going on.

Senator **Mattingly**. And more accurate, is that correct?

Mr. **Moore**. And more accurate.

Senator **Mattingly**. Thank you very much, Dr. Moore. Thank you for coming today.

[Dr. Moore's prepared statement follows:]

ESCALATING SOCIAL SECURITY BENEFITS--A BETTER WAY

Geoffrey H. Moore*

Social security benefits are escalated now by comparing the consumer price index in the first quarter with the index in the first quarter a year ago. This gives a percentage increase at an annual rate. A better formula would be to compare the first quarter's index with the average index over the preceding four quarters, and express this percentage at an annual rate. This is a better formula for several reasons, and right now it would reduce the cost of social security by nearly two billion dollars.

What the formula does is use a four-quarter average as the base from which the percentage increase is figured, rather than a single quarter. The four-quarter average is a better base because it is less affected by special events that may affect a particular quarter. That is, it is more representative of the underlying price level. Also, it is more up to date than the year-ago quarter. The average includes the year-ago quarter and also the three more recent quarters.

By comparing the price index for the first quarter with the average index for the preceding year one gets a more up-to-date measure of what the rate of inflation is. The calculated percentage change does have to be converted to an annual rate, because the interval from the middle of last year to the middle of the first quarter is less than a year. It is, in fact, 7½ months. The annual rate is easily obtained by compounding. If, for example, the first quarter's CPI is 4 percent above the average for the preceding calendar year, the equivalent annual rate is 6½ percent.

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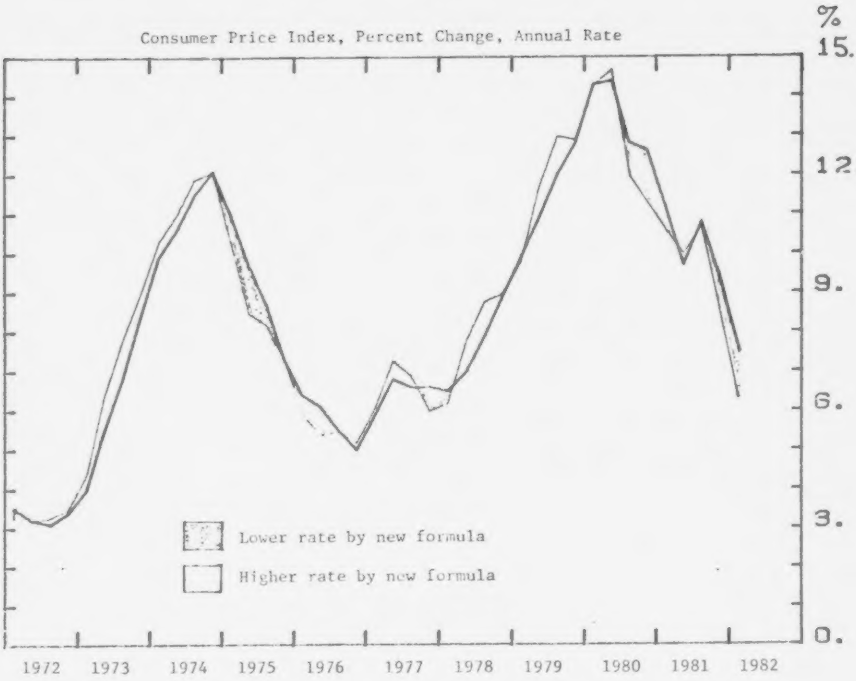
Because the new formula is more up-to-date than the present formula, it is also more equitable. It is closer to the rate of inflation that people are currently experiencing. Thus it helps to meet one of the arguments for more frequent escalation of Social Security benefits, say twice a year rather than once a year.

Finally, it has the important property, when the inflation rate is declining, of yielding a lower rate than the present formula, whereas when the inflation rate is rising it yields a higher rate than the present formula. That is, when inflation is on the rise, the new rate gets up there quicker, so there is less catching up to do. When inflation is receding, the new rate reaches the lower level sooner.

Right now, for example, the present formula applied to the February 1982 consumer price index (using this as an estimate of what the first quarter average will be) shows an increase of 7.5% from the first quarter of 1981. The new formula, based on a comparison of the February CPI with the 1981 average, yields an annual rate of 6.3%. Using the new formula instead of the old would reduce the cost of escalating social security payments by around 1.8 billion dollars this year. Since the 7.5% year-over-year rate is overstating the current rate of inflation, that is a justifiable saving.

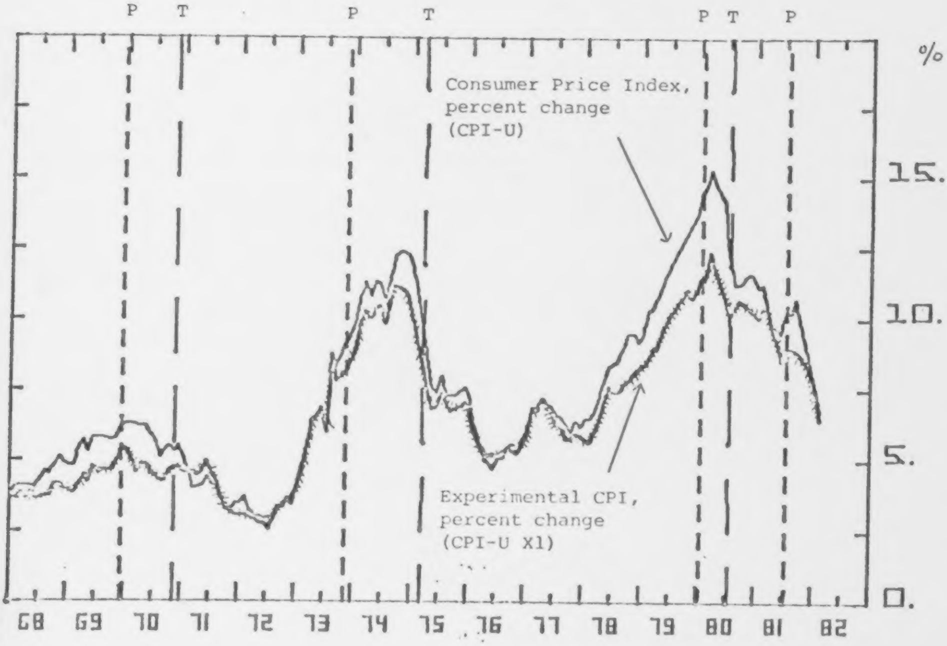
As the accompanying chart shows, over a period of years, with inflation sometimes rising and sometimes falling, the two formulas come out virtually the same. But it would surely be beneficial to avoid over-escalating payments when inflation is trending down, as it is now. That trend needs all the help it can get.

Incidentally, the new formula, which can be applied monthly as well as quarterly, can be used in escalating wages, government pensions, or even tax brackets. The same arguments apply.



Consumer Price Index, Percent Change, Annual Rate

RATES OF CHANGE IN TWO CONSUMER PRICE INDEXES



Percent changes are based on the ratio of the current month's index to the average index for the preceding twelve months, expressed at annual rate. The experimental CPI-U-X1 measures housing costs by the present rent index. Vertical lines are business cycle peaks (P) and troughs (T).

Senator MATTINGLY. We will now move to the first panel discussion. It will be Dr. Oswald of the AFL-CIO, Department of Economic Research and representing the U.S. Chamber of Commerce will be Dr. James Clifton, Director of Inflation Studies.

Mr. Clifton, if you would like, go ahead and make your statement.

TESTIMONY OF JAMES A. CLIFTON, DIRECTOR OF INFLATION STUDIES, U.S. CHAMBER OF COMMERCE, AND RUDOLPH A. OSWALD, DIRECTOR, DEPARTMENT OF ECONOMIC RESEARCH, AFL-CIO

Mr. CLIFTON. Thank you, Mr. Chairman.

I am James A. Clifton, Director of Inflation Studies for the U.S. Chamber of Commerce on whose behalf I am appearing today. I am also a member of the Committee on Price Indices of the Business Research Advisory Council to the U.S. Department of Labor.

On behalf of our 240,000 business, State, and, local chambers and associate members, we welcome this opportunity to present our views on Consumer Price Index reform as it relates to the issue of automatic cost-of-living adjustments and budget uncontrollability.

I want to speak on two related topics today. First, where do we stand on CPI reform and what remains to be done. The second is a more immediate issue. What action, if any, should be taken on the full COLA now paid to recipients of indexed entitlements in light of past flaws in the Consumer Price Index, the inequity in income growth between retirees and workers caused by the full COLA, and the deficit emergency.

I request at this point, Mr. Chairman, that my written remarks be included in the record since I will focus my verbal remarks on the second part of my statement.

Senator MATTINGLY. Without objection both your statement and that of Dr. Oswald's will follow the oral testimony.

Mr. CLIFTON. I want to focus on equity considerations in a 1-year freeze on Federal cost-of-living adjustments.

Congress has deliberated long and hard in budget negotiations this year on the issue of freezing Federal COLA's or paying a COLA at a fraction of a CPI rather than full CPI that is now paid for most indexed entitlements. A COLA freeze has emerged as a result of congressional deficit reduction packages that go beyond the five part deficit reduction plan announced in the President's budget February 8.

The deficit emergency appears to be the only real justification in our view for the tax and defense proposals. By contrast, the economic merit of a COLA freeze can be argued on grounds of equity and fairness alone, quite apart from any other deficit reduction proposal. Federal COLA's are much greater for transfer payments than for wages and salaries in the private sector and recent Federal COLA's, in our opinion, have overcompensated recipients because of serious flaws in the Consumer Price Index of which the homeownership problem is must notorious.

The Congressional Budget Office lists 44 Federal programs whose benefits are automatically programed to increase with inflation, generally as measured by the Consumer Price Index. Together, these programs constitute over 30 percent of total Federal spending. If you add to these the several quasi-indexed programs as listed by the Congressional Budget Office, about half the Federal budget is actually indexed for inflation.

In the past 3 years alone, cost-of-living adjustments for Federal transfer payments have increased spending on these programs by about 40 percent on a compounded basis. Most Federal COLA's compensate fully for increases in the Consumer Price Index, while COLA's in collective bargaining agreements in the private sector average about 58 percent of the CPI. That 58 percent figure is a long run average computed by the Bureau of Labor Statistics for 1968 through 1981. The vast majority of working citizens, of course, have no automatic cost-of-living protection at all.

BLS reports that 5.1 million employees in major collective bargaining agreements were covered by COLA's in 1981. That is about 5 percent of the total civilian population. There is, of course, some inflation premium built into the market apart from formal COLA's and the BLS data do not cover all workers, but these factors do not at all change the general picture.

Largely because of this fundamental inequity in COLA protection, wages and salaries of working citizens have increased more slowly since the early 1970's than indexed transfer payments of which social security is the largest. With increases in each of the last 3 years, social security withholding taxes are now as high as the Federal income tax for the typical working citizen. These ever higher taxes are not being put into trust for the young when they retire, but are being paid out immediately to retired persons as a result of uncapped growth in their per capita benefits.

As a result of these inequities, permanent modifications to Federal COLA formulas have been surfacing ever since 1979. Indexing Federal transfer payments to the lesser of the rise in the CPI or average wages has been proposed as reestablishing equity in income growth between working citizens and transfer payment recipients. This proposal has now lost steam because it would contribute little to budgetary savings in the outyears where wages are now forecast to increase faster than prices, which hopefully is the normal historical circumstance. Even so, this "lesser of" proposal is based on a severe misunderstanding of the equity issue which is one of comparability in COLA protection, not comparability in income growth between different segments of the population.

Such wage indexing as has been proposed in the "lesser of" proposal would freeze the distribution of income between different segments of the population. For markets to operate efficiently, wages and salaries must be free to fluctuate up and down in relation to one another in response to changes in productivity, shifts in the demand for skills or shifts in the relative prices of capital, labor and resources. Wage indexing such as proposed would virtually hinder the market mechanism from performing each of these functions.

The spotlight for permanent COLA reform in the Federal budget is now on CPI minus 3 percent and I believe a flat 4 percent COLA has been suggested in the quiet budget negotiations by Chairman Jones. These proposals would save considerably more money than the "lesser of" proposal while addressing in some fashion the equity problem I mentioned earlier.

A straight percentage of CPI, such as CBO's two-thirds of CPI proposal, or 60 percent of CPI, which would be comparable to private sector COLA's, would probably generate greater equity with private sector COLA's in the long run. Different inflation rates would not lead to wide swings in degree of protection with a percentage cap such as would CPI minus 3 percent.

A temporary freeze on Federal COLA has been proposed as an alternative to a permanent modification of the indexing formula this year.

The political climate of an election year and added weight of the President's Bipartisan Commission on Social Security Reform, which is due to report in December, are the main reasons for this shift in focus. The U.S. Chamber of Commerce supports the proposal for a 1-year freeze on Federal COLA's.

Aside from equity in fiscal restraint, what is the economic rationale for a 1-year freeze? One rationale, of course, would be to correct the income transfers of the past few years that are due to inequities in COLA protection. These inequities, quantitatively, look like the following. Since 1975, when social security became automatically indexed, social security benefits have increased on average 19 percent faster than wages and salaries in the private sector.

But there is a second, less well-understood equity issue that in and of itself would fully justify a 1-year freeze on Federal COLAs. Overpayments for increases in the cost of living made recently because of flaws in the CPI.

Using a measure of underlying inflation supplied by BLS which nets out supply shocks and the homeownership problem from the CPI, and also adjusting for the notorious substitution bias, we estimate that $21 billion in excessive Federal COLA payments have been made since 1978.

I constructed that figure last November in connection with a conference which the chamber sponsored on Consumer Price Index reform. Almost by pure coincidence, that happens to be the amount that OMB and CBO now estimate would be saved for fiscal year 1983 by a 1-year freeze.

The primary stumbling block to a freeze on Federal COLAs is the widespread myth that everyone over 65 is poor and needy. In 1980, 15.7 percent of the elderly were classified as below the poverty line, less than half of the 1959 figure of 35.2 percent and about the same as the 13 percent incidence of poverty among the general population. These poverty figures are based on before-tax income and they do not reflect substantial noncash benefits received by retired persons which make up over 23 percent of their total income.

If after tax incomes are compared and inkind transfer payments are added to money incomes, the incidence of poverty is almost twice as high for those under 65 as for those over 65. Those CBO figures are for 1976, 7.6 percent versus 4.1 percent. This study should be updated beyond 1976 data because it has been in the past 3 years, 1979, 1980 and 1981, that inequities in COLA protection between retirees and the general population have been the most severe. A just released Census Bureau study using 1979 data shows roughly the same pattern of the incidence of poverty on an after transfer payment basis.

Discretionary programs benefiting millions of Americans are being squeezed again in the President's budget this year as in 1981 because that is the political path of least resistance. Against this backdrop, we understand many Members of Congress are proposing new legislation for the aged this year.

Whether Federal COLA's will be frozen or not for a year is still an open political question, despite recent evidence of wage and COLA concessions in collective bargaining agreements, of which there are several examples. Thirty-six million citizens receive social security benefits funded by 98 million working citizens of whom 68 million are under 45 years of age. If these 68 million wake up to the fact that they are being peppered to death with high interest rates caused in part by uncontrolled indexation, we believe economic recovery may at least begin.

While it is not part of my prepared remarks, I would like to discuss just a moment some preliminary results of a Gallup survey we had conducted and which has just now been completed on social security and cost of living adjustments.

Senator MATTINGLY. Yes, please do.

Mr. CLIFTON. The results, we believe, are timely and fascinating based on our preliminary analysis. The full report of this survey which was commissioned by the chamber will be ready next week. But here are some highlights. When asked "What do you expect when you retire, will social security benefits you receive be better than those received by retired people or not as good, or are you afraid you might not receive social security payments at all?" Sixty-three percent of those currently employed said they were afraid they might not receive any social security at all upon their retirement. This answer appears to be based on correct knowledge about financial problems in the system.

Eighty percent of all respondents to the Gallup survey believed the social security system has major financial problems.

Senator MATTINGLY. How many?

Mr. CLIFTON. Eighty percent. Fifty-two percent believe the system will have trouble meeting its financial obligations within 5 years and 50 percent believe the system now pays out more money than it receives.

Among those respondents currently employed, 55 percent believe the system now pays out more than it receives.

A second major finding of the Gallup survey is the general level of ignorance about the social security system. The method of our survey was to ask at the start of our questionnaire several control questions and then to introduce facts as we went along and note the change in response, if any. Our very first question read, "Thinking about the amount of social security benefits the Government pays retired people and taking into consideration everything else the Government spends money on, do you think the social security payments which people are receiving are higher than they should be, lower than they should be, or are just about the right amount?" Not surprisingly, 57 percent answered that the benefits are lower than they should be. However, when informed that social security benefits have risen 40 percent in the past 3 years due to automatic COLA's alone, only 38 percent thought there should have been a larger increase.

Of equal significance in our opening question, it is the currently employed who feel benefits are lower than they should be. Sixty-one percent said they were lower than they should be. While 55 percent of the retired feel they are adequate at their current level, only 35 percent of the retired thought they were lower than they should be.

The problem of knowledge I alluded to earlier is especially evident in responses to two other questions. Sixty-one percent of those currently employed believe social security income goes up by less than the CPI while only 41 percent that are retired believe this. Forty percent of those currently employed mistakenly believe the talk of budget cuts in social security means reducing the dollar amount of social security checks while only 17 percent of the retired believe this.

Senator MATTINGLY. Will you rephrase that one for me about what they think will happen, they think it will go up?

Mr. CLIFTON. Yes; 40 percent of those currently employed mistakenly believe the talk of budget cuts, which I understand to be talk of cuts in the rate of growth of benefits, and at most freezing benefits at their current level for 1 year, means reducing the dollar amount of the check. Only 17 percent of those who are retired so believe.

Senator MATTINGLY. They understand it.

Mr. CLIFTON. They understand it much better than the employed. And in general, answers to these questions show the political obstacles faced by Congress on short-run actions on social security are less among the retired population, interestingly enough, than among the currently employed.

Equity in COLA protection is an important issue for respondents in this Gallup survey. Among those who believe that Government should pay an automatic COLA, 73 percent felt Federal COLA's should be equal to private sector COLA's, the 60 percent average figure I mentioned. I have saved for last what may be the most interesting political finding in the survey. We asked the following question: Which political party do you think is playing the more responsible role in trying to get Social Security back onto a more sound financial footing, Republicans, Democrats or are the two parties about equal in this respect? Out of our total respondent population, 19 percent believe Republicans will be more responsible, 22 percent believe Democrats will be more responsible. Thirty percent said the two parties will be equally responsible in solving the system's problems.

Among those currently employed, 22 percent said Republicans would be more responsible and virtually the same percentage, 22 percent said Democrats would be more responsible.

Eighty percent of respondents said a Presidential Commission on Social Security Reform should be made up of half older and half younger citizens. The average age of the actual Commission, by the way, is 58.

Fifty-nine percent of respondents said a 1-year freeze on social security benefits either would not be an important election issue for them or would make them more favorably disposed in voting for a Member of Congress. Of special significance, there was no difference at all between retired and currently employed on the issue as to whether they would be more likely to vote or be less likely to vote for a Member.

Thank you very much, Mr. Chairman.

Senator MATTINGLY. Thank you, Mr. Clifton. That is very enlightening, and I think the figures you are going to make public next week, or I guess they are public now——

Mr. CLIFTON. Some of the figures that are public now are analyses and results of our survey that will be made fully public next week.

Senator MATTINGLY. Can we make a copy of that right now?

Mr. CLIFTON. Certainly.

[The information referred to follows:]

ADDITION TO DR. CLIFTON'S TESTIMONY

Senator, I would now like to turn from my written testimony to discuss results of a survey on Social Security and COLAs just completed for us by the Gallup Organization. The results are timely and fascinating, based on our preliminary analysis. The full report will be ready next week. Here are some highlights.

When asked "What do you expect when you retire—will the social security benefits you receive be better than those received by retired people today, or not as good, or are you afraid you might not receive social security payments at all?", 63 percent of those currently employed said they were afraid they might not receive any Social Security at all upon their retirement. This answer appears to be based on correct knowledge about problems of the system; 80 percent of all respondents believe the Social Security System "has major financial problems;" 52 percent believe the system will have "trouble meeting its financial obligations "within 5 years, and 50 percent believe the system now pays out more money than it receives. (55 percent of those currently employed believe the system is now paying out more than it receives.)

A second major finding of the survey is the general level of ignorance about the Social Security System. The method of our survey was to ask at the start a set of control questions, and then to introduce facts as we went along and note the changes in response, if any. Our very first question read, "Thinking about the amount of social security benefits the government pays to retired people, and taking into consideration everything else the government spends money on—do you think the social security payments retired people are receiving are higher than they should be, lower than they should be, or are just about the right amount?"

Fifty-seven percent answered that benefits are lower than they should be. However, when informed that Social Security benefits have risen 40 percent in the past 3 years for automatic COLA alone, only 38 percent thought there should have been a larger increase.

Of equal significance on the opening question, it is the currently employed who feel benefits are lower than they should be (60 percent); 55 percent of the retired feel the level is satisfactory and only 35 percent feel they are too low.

The problem of knowledge I alluded to earlier is especially evident in two other questions; 60 percent of those currently employed believe social security income goes up by less than the CPI, while only 41 percent of the retired believe this; 40 percent of those currently employed mistakingly believe that talk of budget cuts in Social Security means reducing the dollar amount of the checks, while only 17 percent of the retired believe this. Thus, the political obstacle faced by Congress in short run actions on Social Security are less among the retired than others in many ways.

Equity in COLA protection is an important issue for respondents. Among those who believe government should pay an automatic COLA, 73 percent felt federal COLAs should be equal to private sector COLAs.

I have saved for last what may be the most interesting political finding of the survey. We asked "Which political party do you think is playing the more responsible role in trying to get social security back onto a more sound financial footing—Republicans, Democrats, or are the two parties about equal in this respect?" 19 percent believe Republicans will be more responsible, 22 percent believe Democrats will be, 30 percent said the two parties would be equally responsible. Among those currently employed, 22 percent said Republicans would be more responsbile, and 22 percent said Democrats would.

Eighty percent of respondents said a Presidential Commission on Social Security reform should be made up of half older and half younger citizens. (The average age of the actual Commission is 58 years, by the way.)

Fifty-nine percent of respondents said a one year freeze on Social Security benefits either would not be an important election issue for them or would make them more favorably disposed in voting for a member of Congress. Of special significance, there was no difference at all between retired and currently employed respondents on this issue.

Senator MATTINGLY. Dr. Oswald.

Mr. OSWALD. Mr. Chairman, I thank you for this opportunity to present the views of the AFL–CIO on this issue of the Consumer Price Index and automatic cost-of-living adjustments. I ask that my entire statement be made part of the record and I would like to highlight certain parts of my testimony.

Senator MATTINGLY. Without objection.

Mr. OSWALD. We believe that the most important equitable means of dealing with this issue is to develop a separate suitable index to represent the retired or aged population for whom inflation has different impacts than for either the population in general or for wage earners or clerical workers in particular. And I would like to point out why there are these differences.

First of all, the CPI–U does not really represent the buying patterns of the retired population currently any better than the CPI–W. The CPI–W excludes the expenditures of this population but the CPI–U drowns them out. Expenditures of families headed by persons age 65 and older make up only a small portion of the total family expenditures of those that are included in the CPI–U, less than 12 percent of the total expenditures of the total population.

There is a distinct difference between the type of expenditures that famlies with heads over age 65 make as compared with the population as a whole. My testimony has a table describing in detail what those expenditure differences are, but let me just highlight some of those differences.

One of the basic questions you are looking at deals with home purchase outlays, and there is a substantial difference. Whereas 10.9 percent of expenditures of the general population are for home purchase outlays, only 4.3 percent obtains for families with heads age 65 and over. Mortgage interest costs were 5.2 percent for all families, but only 1.7 percent at age 65 and over.

In contrast to the general population, most older families have already bought their homes and are no longer incurring mortgage payments. But, on the other hand, important elements of homeownership are very important for the aged population, particularly property taxes, insurance, maintenance and repair. All are much larger expenditures for the aged population than for the general population.

For the aged population, they comprise 7.7 percent of outlays, as compared to 4.7 for the general population. There are other significant differences in how older people spend their money.

Older people spend a much larger proportion of their money for foods, some 21 percent compared to 17 percent for the general population. Fuel and utilities also are a much larger percentage of expenditures for older people, 9 percent versus 6 percent. For medical care, the figure is nearly 10 percent versus 5½ percent for the general population.

It is these differences in the spending patterns between the aged and the general population that we believe is and should be the basis for a separate index to be developed. Congress should provide the funds to the Bureau of Labor Statistics for doing that particular element. The question of shifting the index for social security and other purposes toward using the CPI–U rather than the CPI–W has been complicated by the change in the homeownership component for both indexes, thought they have different effective dates. The CPI–U, as you know is January 1983 and the CPI–W is January 1985. We have been very concerned with the change-over, which involves the dropping of home purchase as a direct component in the CPI.

These specific homeownership cost indexes would be replaced with a price index for rental housing that is currently only in an experimental index. We believe that homeownership reflects what Americans actually purchase in the marketplace. Most American families are living in owner-occupied dwellings. Since homes are what people actually buy, with mortgages incurred, it seems to us a mistake to pretend that they are renting. And if we look at the aged particularly, two-thirds of the aged own their own homes.

The question of rental equivalency has been one that has been talked about for quite awhile, but we have often neglected the basic differences between those homes that are rented and those that are owned.

Most rental housing is apartment housing. It differs in its characteristics, such as size, location, age of structure and the types of occupants. Rental housing often comes under rent controls while owned housing does not. And the American dream of owning a home with its special costs, cares and benefits is hardly captured in a rental equivalence measure.

The problem of finding enough rental housing similar to owned housing to serve as the basis for a rental equivalence index has been a sticky one even for the proponents of this methodology, and we don't believe that that issue has been resolved by the proposals made by the Bureau of Labor Statistics to deal with that issue.

Next January, when CPI–U moves to rental equivalency, we will have only a very partial, half baked process for dealing with that issue. All that will happen is that the existing rent sample drawn to represent rental housing and not owned housing will be rearranged to give more weight to rents in neighborhoods where the proportion of owned homes is largest and less weight to areas with the smallest proportion of owned houses.

In the second stage, we will have an enlarged rental sample to include rents in areas predominantly owner-occupied but that will not be until January of 1985.

As labor representatives, we have a particular, practical reason for opposing any acceleration in a conversion schedule for CPI–W. Most labor contracts use CPI–W with existing contracts expiring at various times between now and 1985. If major alteration in the basic computation in the index is made, such as the housing change represents, it would invite disputes over the validity of existing COLA provisions.

Some contracts would then need to be renegotiated or the whole contract opened up for question in terms of how the contract itself provides for the actual changes that are provided for in those cost-of-living escalator clauses.

We believe that the possible disruptive impact of CPI changes for existing agreements is in itself sufficient reason not to install rental equivalency for the CPI-W before January 1985.

Mr. Chairman, we favor the development of a special index for aged or retired beneficiaries which could be used for the escalation of benefit payments under benefit programs.

We believe this is a better solution than using either of the existing indexes. We think it is important for price indices to reflect the actual types of costs incurred by populations with significant differences in their manner of living.

Certainly the difference between the working population and retired population is significant and should be recognized in the construction of price indices for use in Government programs.

Merely transferring beneficiaries to a rental equivalence index at the earliest possible date would smack strongly of an effort to reduce benefit outlays as speedily as possible without regard to the actual situation of those affected.

We oppose an effective date for rental equivalence any earlier than January 1985 for either of the present indices.

Mr. Chairman, that concludes a summary of my formal presentation.

Senator MATTINGLY. Thank you, Dr. Oswald.

I would like to ask you both questions.

Do you both agree that the CPI, as currently calculated, has been misused by the Congress? I will start with that question first. Do you believe the CPI is flawed?

Mr. OSWALD. I believe that the CPI currently attempts to measure as accurately as possible what it purports to measure, and that is price change for goods under the CPI-U, in what the general population purchases, or for the CPI-W, going back to 1917, in what the working people tend to buy.

We believe that a better measure of what retired people buy could and should be developed to accurately measure their spending patterns and to be used as an escalator for those programs that reflect the living expenses of retirees. Your chart indicates that a very large portion of program expenditures are used for retirees.

Senator MATTINGLY. Dr. Clifton?

Mr. CLIFTON. I do not believe the CPI is flawed in terms of measuring the changes in cost of living for retirees as against other groups. I might point out Mr. Minarik from Brookings has produced a study showing the differences in cost of living for retirees do not significantly differ from those of the general population.

Mr. Minarik repeats that in testinony before this subcommittee that I looked at today. Mr. Hageman from BLS has produced similar findings and Mrs. Rivlin's testimony today also suggests there is no significant difference. Mr. Harry Havens, whose testimony is being offered today, suggests there is no significant difference. That is the GAO study.

I do believe, however, that there are significant flaws in the Consumer Price Index. In that part of my testimony that I did not read, I do highlight and try to estimate both the extent of the homeownership bias and another bias called the substitution bias which results from the fact the Consumer Price Index uses what is called a fixed market basket approach to measure changes in cost of living. In essence it does not allow overtime for the fact that people respond to increases in the price of lettuce by substituting spinach or fruit salad.

Although the bias in the CPI from not allowing for such substitutions is small, roughly four-tenths of 1 percent recently, we did calculate that that small bias, given the magnitude of indexed Federal transfer payments did cost the Federal Government almost $2 billion in excessive transfer payment benefits in the past couple of years. So the money is not insignificant even though the size of the bias may be small.

There is a difficult issue which I have also listed called supply shocks. You can call this a bias in CPI. As Mrs. Norwood correctly pointed out it really is not a flaw in the index but virtually all leading economic experts across a wide political spectrum that I am aware of agree fully at the level of economic theory that it is very counterproductive for a country to try to index against the type of catastrophic price indexes we had in energy, for example, in the seventies.

When you try to index for price increases which are due to declines in national income, and represent a real shortage, you force the nonindexed part of the population to bear the entire burden of such shortages.

We think that is very inequitable. We think it is an anomaly that has happened because of the very complex system we have today in our economy.

If you were to look at the situation 150 years ago where you had three generations living on a family farm and that farm experienced a loss in its income, namely a crop failure, let's say, for 1 year, you all know fully well that it is not only the working generation who would have sacrificed because of that shortage.

My folks, who are retired in Florida, certainly would have offered to pull in their belts a little bit, too, but since the CPI unavoidably includes price increases which are due to supply shocks, retirees are now compensated for those supply shocks and the result is, as I mentioned, that the working generation bears the full burden of the higher energy prices.

Retirees don't have to economize on oil when the price of oil increases because they are fully indexed against it.

The working generation is the one who has to bear the brunt of that shortage.

Senator MATTINGLY. Do you both agree there ought to be a CPI for retirees?

Mr. OSWALD. I believe there should be, yes.

Senator MATTINGLY. Dr. Clifton?

Mr. CLIFTON. I do not believe there should be, in light of budgetary constraints and the research which I have mentioned which suggests there is no difference between cost of living for retirees and others on balance.

Mr. OSWALD. There are substantial differences for particular items within the cost-of-living expenditure patterns of retirees, particularly for food, particularly for medical care and in the housing area also.

When these items within the index move at different rates as they have frequently moved, we believe that an index that more adequately reflects what happens to retirees is a better measure.

I think there is one other reason for doing it. And that is an understanding and acceptance by people who are indexed in knowing that the index particularly reflects their own spending patterns.

It is very difficult to justify to retirees why we are using an index that includes the total population or, currently, the working group of clerical workers and wage earners as the basis for adjusting their payments when what they are spending for medical care and food particularly, and also somewhat for utilities, differs substantially. Their price movements may differ from those populations.

Mr. CLIFTON. If I could just finish my answer. It is quite true as Dr. Oswald points out that individual items in the CPI can differ between retirees and others. The weights are different, for one thing. But in the end they wash out. I have just listed five pieces of evidence that suggest overall that there are no differences between the two items, so we would not support the creation of a separate index.

I also might point out with regard to the homeownership issue, it is true that between 70 and 80 percent of retirees own their own homes.

According to the CBO study I mentioned, 70 percent of those have fully paid up mortgages. How can you pay through social security an increase based on the CPI which is being driven by an increase in home prices when, in fact, that increase in home prices for those who already have fully paid up mortgages or who already have mortgages represents an increase in wealth?

It does not represent an increase in their cost of living, it represents an increase in their wealth. Yet, since the CPI is constructed the way it is, that increase in wealth is treated as if it is an increase in the cost of living when in fact it is not.

With regard to the issue of switching to rental equivalence, it has been pointed out this is an experimental measure. Rental equivalence in its present form is what was used in the Consumer Price Index over most of its history. Rental equivalence was the homeownership measure in the CPI since its inception in the 19's up until 1953. Moreover, rental equivalence is what is used as the official index in other industrial countries, consumer price indexes. Furthermore, it is rental equivalence which is used in the U.S. Department of Commerce's personal consumption expenditure deflator, which has oftentimes been touted by experts as being superior to the CPI because it does use rental equivalence and does not use the existing homeownership measure in the CPI.

Senator MATTINGLY. If we take out the rental equivalence of the home mortgage and try to, for the retirees, work to the 30 percent that don't own their own homes, because 70 percent do own their own homes, what would we factor in there to compensate for that 30 percent and how would you identify that 30 percent?

Mr. OSWALD. I think you would do the same as you have been doing historically for the current type of index. Under the current type of index prior to the change that is being proposed for homeownership, you have a weight for rental that is equivalent to the expenditures of that proportion of people who rent and you have a weight for homeownership expenditures that is proportional to those who own their homes. And I would think that if you did a separate index for the aged, you would similarly maintain a proportion for the 30 percent who rented. For those who own their own homes, you would include weights for such homeownership elements as taxes, home maintenance and repairs proportionate to what those total expenditures are for people in that age group.

Senator MATTINGLY. Don't you both agree that the CPI, as calculated, has caused overcompensation in the past?

Mr. OSWALD. No; I would not say that it has caused overcompensation. The CPI, as calculated, I believe, reflects accurately what takes place for the general population. I don't think that we really know what would have happened for the aged if there had been a separate index. I do not know if it would be higher or if it would be lower. The problem is that we just not develop that separate index.

Senator MATTINGLY. In reference to equity, though, to wage earners, there is not any reference to that.

In other words, increases by wage earners versus increases in indexed programs in the Federal Government are quite different. Is that correct?

Mr. OSWALD. I don't think that there has been a change in equity in terms of providing essentially for those who traditionally have been the weakest in our society with a recompense that may have been higher than that achieved by the wage earner in the very recent time period because many wage earners' increases had failed to keep up with the change in the cost of living as measured by the CPI. I think that maybe what we have achieved may be an improved element of equity if those who are the least able in our society have not had their real income cut as much as those who are working who suffer also from that real income cut, but may not be the weakest in our society.

Mr. CLIFTON. I said in my prepared remarks pretty much what my feelings are. I think Dr. Oswald's statement, with all due respect, and we do agree on some things, such as the change in CPI-X1, which undoubtedly should not take place until 1985, I agree with that fully, but I think that we suffer a 20-year lag in this country about our perceptions of the retired. It is quite true that in 1959 a very high percentage of our retired citizens were in poverty as measured by the Government, 35 percent is the official figure. To have gotten that down by over 50 percent within 20 years is a notable achievement, one that everybody should be proud of, both within the Congress and around the country. But the facts of the matter are, and they are reiterated by the study just released by the Census Bureau, that if you look at the incidence of poverty after you include in-kind transfer payments, the incidence of poverty is now lower, significantly lower, for those people who are retired than for those who are under 65. And I just do not agree with the assertion that our retired are the weakest part of our society. I do not think that is true any more.

I think it is a misperception based on what the situation was 20 years ago. I think it is very much not within the public interest to be continuing these misperceptions.

Mr. OSWALD. If I may, I think that the indexing that has taken place since 1959 has been a major element by which the poverty of the retirees has been brought down to nearly the same level as it exists in the general population today so that we do not have the disproportionate level that existed in 1959.

Mr. CLIFTON. I would like to point out, if I may, Dr. Oswald, that the indexing of social security benefits was not started until 1975; it was not started in 1959.

Mr. OSWALD. I am saying since. Another very important element was medicare which was started in 1965, but in-kind measures are not appropriate. To look at what medicare means for particular retirees and to somehow say that medicare for the health problem of retirees should somehow be included in a measure of how and when they are in poverty and to offset the income for which they need to live on on a day-to-day basis I think is inappropriate in terms of measuring.

The largest in-kind elements that are received by those near and in poverty that are not counted in the official poverty reports are elements like health care payments, and those are precisely the elements that are unique to people that are near poverty, and which do not relieve their poverty, that are major elements——

Senator MATTINGLY. I agree, Dr. Oswald. What we are talking about is the CPI itself. Is it, in fact, a calculation that is overcompensating, undercompensating, or does it need to be revised? You say we need a CPI–R. Therefore, the one we have got does not fit the mold. I appreciate you both coming today. I thank you.

Dr. Oswald was not here when you made your statement, Dr. Clifton, on the survey. I think you might want to give him the benefit of that survey.

Mr. CLIFTON. I will be happy to do that.

Senator MATTINGLY. Good. Thank you both very much.

[The prepared statements of Drs. Clifton and Oswald follow:]

STATEMENT
on
CONSUMER PRICE INDEX REFORM AND THE INDEXING OF FEDERAL TRANSFER PAYMENTS
before the
SENATE COMMITTEE ON GOVERNMENTAL AFFAIRS
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
Dr. James A. Clifton
April 20, 1932

I am James A. Clifton, director of inflation studies at the Chamber of Commerce of the United States, on whose behalf I am appearing today. I am also a member of the committee on price indexes of the Business Research Advisory Council to the Department of Labor.

On behalf of our 240,000 business, state and local chamber and association members, we welcome this opportunity to present our views on Consumer Price Index (CPI) reform as it relates to the issue of automatic cost-of-living adjustment (COLA) clauses and budget uncontrollability.

I want to speak on two related topics today. The first is: where do we stand on CPI reform, and what remains to be done. The second is a more immediate issue: what action, if any, should be taken on the full COLA now paid to recipients of indexed entitlements in light of past CPI flaws, the inequity in income growth between retirees and workers caused by the full COLA, and the deficit emergency.

SUMMARY

- The recently announced change in the measurement of homeownership costs in the Consumer Price Index is a welcome improvement in the accuracy of the CPI that is long overdue.

- Based on historical evidence, it is uncertain whether the new "rental equivalence" measure of housing costs will lead to a more slowly rising CPI or a faster rising CPI. Nonetheless, the change can be supported because it will create a more stable index, which is also more accurate.

- The announced timetable for changing the CPI, 1983 for CPI-U and 1985 for CPI-W, has advantages and disadvantages. Two official inflation indices which differ markedly may be confusing to the public. But that may help highlight the fact that no one measure of inflation is appropriate for all uses, and better enable COLAs to be tailored to individual situations.

- The best forecast data suggest CPI-U will rise more slowly than CPI-X1 (rental equivalence) in the next few years. On these grounds, the announced timetable for changing CPI-W in 1985 should remain, so some "downside benefits" can be realized which at least partially offset the upward bias in the CPI of the past few years.

- Altogether, CPI flaws and the misuse of COLAs in indexing for supply shocks has led to $21 billion in excessive federal COLA payments since 1978. A one-year freeze on COLAs, July 1, 1982 - July 1, 1983 would just offset these overpayments, while contributing substantially to deficit reduction and lower interest rates.

- Past inequities in COLA protection between the private sector and government have led to Social Security benefit increases far outstripping increases in wages and salaries since 1975.

- Permanent COLA reform in federal transfer payments should be based on the principle of equity with COLAs negotiated in collective bargaining agreements in the private sector. These COLAs average 60% of CPI, not the 100% of CPI paid under most federal COLAs.

ISSUES OF CONCERN IN THE PROPOSED CHANGE TO THE CONSUMER PRICE INDEX

The change in measurement of homeownership costs in the Consumer Price Index announced by the Bureau of Labor Statistics last October is a welcome improvement in the accuracy of that index. It is a change that was long overdue, because the present flaws in shelter cost measurement led to overpayments of almost $10 billion in indexed federal transfer payments from 1978-1981. It is a change, however, that will not affect federal spending until FY 1986.

The change to a rental equivalence measure of homeownership costs (CPI-X1) is really a change *back to* rental equivalence, which was used in the CPI before 1953 as the official measure of homeownership costs. Rental equivalence has always been used in the Department of Commerce's personal consumption expenditure deflators, and it is generally the way homeownership costs are measured in other countries' retail price indexes.

Under the proposed change, two issues have arisen within the business community: the timing of the change, specifically changing CPI-U (all urban workers) and CPI-W (urban production and clerical workers) at different dates, and changing them in 1983 and 1985 rather than sooner; second, the absence of "appropriate linkage" between the old index and new index which would "eliminate" the upward bias from past mismeasurement now built into the existing index number.

In testimony presented before Congress last November 17, and in our official reaction to the announced change in the CPI, we cautioned that a change to a rental equivalence measure of homeownership costs would not necessarily produce a more slowly rising CPI, especially in the short-run, but we defended the change on two other grounds.

First it will create a more accurate inflation index, and that is of importance to in an age of inflation. A biased measure of inflation will lead to an incorrect price policy and wage policy. For example, if a supplier has to raise prices to ration a product in short supply, measure of inflation is downward biased, his price increase will not be sufficient to accomplish the goal, because it must be at a *premium* above the (correctly measured) general rise in prices.

Second, the change will lead to a much more stable CPI. This is important because it will enable a better prediction of labor costs where COLAs are a factor. It is also important because, under Financial Accounting Standards Board Rule 33, a more stable CPI will not lead to wide and misleading swings in reported real earnings, as has been the case in recent years.

The announced change is especially important to sound economic policy. The implementation of Credit Controls in March of 1980, which precipitated the 1980 recession, was a direct result of a volatile CPI telling us inflation was 18% when the underlying rate was closer to 9% (with other inflation measures only slightly above that).

What about the comparative increase between the present homeownership measure and rental equivalence in the future? The past record indicates a rental equivalence measure will not necessarily rise more slowly than the present index in the long-run.

As indicated in Table One, from 1953-1967, CPI-U rose somewhat less on average than the implicit price deflator for personal consumption expenditures (PCE). Most of the difference is due to the fact that the PCE uses a rental equivalence measure of homeownership costs, while the CPI-U from 1953 on has used the present method of homeownership cost measurement. (A small part of the difference is due to the latter being an index with a flexible market-basket reflecting changing buying patterns, while the CPI uses a fixed-weight approach.)

However, from 1967 to 1981, the CPI-U has risen on average 1% per year faster than the PCE, just the reverse behavior of the previous 14 years.

TABLE ONE

Three Measures of Consumer Prices, 1947-81

	Consumer Price Index (CPI-U)	Experimental Consumer Price Index (CPI-U-X1)	Personal Consumption Expenditures Deflator
		1967=100	
1947	66.9	n.a.	65.0
1953	80.1	n.a.	77.6
1961	89.6	n.a.	89.3
1967	100.0	100.0	100.0
1981 (3rd qu.)	276.1	250.9	240.7
		Percent change per year	
1947-53	3.0		3.0
1953-61	1.4	n.a.	1.8
1961-67	1.8	n.a.	1.9
1967-81	7.5	6.8	6.5

Note: Before 1953 the CPI measured all housing costs by rents, as does the experimental CPI (col.2). Since 1953 the homeownership sector of housing costs has been measured by house prices, mortgage interest, property taxes and other expenses. The personal consumption expenditures deflator uses rents throughout.

Source: Center for International Business Cycle Research, Rutgers University, Newark, New Jersey

What about the recent increase of CPI-U compared to CPI-X1 using rental equivalence? As is clear from Table Two, in 1981 CPI-U was still rising faster than CPI-X1 on a year over year basis. However, in the first quarter and in May 1981, X-1 was rising faster, and since last September X-1 has been rising considerably faster than the official homeownership measure. Is this recent pattern likely to continue and if so for how long?

TABLE TWO
Recent Behavior of Measures of Homeownership in the CPI

	(percentage change)	
	Official	X1
unadjusted, Dec. 1981		
from Dec. 1980	10.1	8.5
unadjusted, Jan. 1981		
from Jan. 1980	9.4	8.4
Seasonally adjusted, 1981		
Dec.-Jan.	0.5	0.7
Jan.-Feb.	0.0	0.5
Feb.-Mar.	0.3	0.5
Mar.-Apr.	0.7	0.6
Apr.-May	1.7	0.8
May -June	1.5	0.4
June-July	2.1	0.5
July-Aug.	1.1	1.2
Aug.-Sept.	1.6	0.8
Sept.-Oct.	-0.3	0.8
Oct.-Nov.	0.2	0.7
Nov.-Dec.	0.2	0.7
Dec.-Jan.	-0.1	0.6

Source: Bureau of Labor Statistics

I have spoken recently with some leading national experts on this issue. They suggest the balance of supply and demand factors that rental prices will be rising faster than the prices of new and used homes until the middle of the decade.*

For this reason, we tend to believe Congress should not press for CPI-W to be changed to the rental equivalence measure at the same time the CPI-U is changed in January of 1983. By waiting until 1985, the scheduled date for the CPI-W change, we will realize "downside benefits" for indexed federal programs from slower increases in the official homeownership measure which to some small degree compensate for the upward bias we've had in the past few years.

We noted at that time that having two official inflation measures that were significantly different for two years would be very confusing to the public, and, therefore, that the change should be made simultaneously. However, there is virtue in not having a single measure of official inflation. The fact is, there simply is no one best measure of inflation for all seasons and places. That is the "bottom line" lesson for economists from the CPI measurement debate of the past few years. With two (or more) official measures, which will probably differ somewhat, public opinion can begin to focus on the real issue of concern to experts: the use of inflation indices for inflation adjustment clauses and the determination of which price increases can legitimately be compensated for and which cannot. This should enable institutions to better tailor COLAs to their own individual situations -- for example, taking the rapidly rising health care component out of a wage COLA if employees are already covered by a health plan, omitting the homeownership component if almost all employees rent or already own homes, or omitting from the COLA isolated price shocks due to economic shortages or foreign cartels.

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* The demand side of the market for owned homes will be weak in the 1980s for several reasons. Family formation is expected to be lower in the 1980s, after being rapid in the 1970s. Interest rates will be higher and expectations of appreciation, (demand for a home as an inflation hedge), will be lower. Because of these demand depressants, prices for homes will probably not rise as fast as inflation in the next few years. Mortgage costs may fall somewhat, but interest rates will remain high in real terms, though lower than now. All these factors, by keeping the cost of homownership high will make demand weak.

In the 1970s, real rents lagged behind the rise in home prices, and have as yet not really followed the rise in real interest rates as rents typically do. While the expectation is that rents will rise as real interest rates remain at historic highs, there is a countervailing force putting downward pressure on rental prices, the ACRS provision of ERTA, which is an excellent tax break for rental unit owners.

In summary, the relative behavior of rental prices and home prices is likely to be dominated by weak demand in the latter market. However, this period of disequilibrium adjustment in the real value of homes is likely to be finished by 1985.

The Business Research Advisory Council to the Department of Labor recently passed the following recommendations. First, CPI-U and CPI-W should be changed at the same time, with no date specified for the change. Second, CPI-W should be dropped at the earliest appropriate time, in order to save money. Third, a Bureau of Labor Statistics (BLS) research paper should be written showing what the CPI would have been in the past, had rental equivalence been the official housing measure. While we are skeptical about the first recommendation, we do believe the second and third recommendations are sound. The third would provide a sound technical basis for reducing future federal COLAs as a result of past overpayments.

With regard to "appropriate linkage", it would be sound economics to reduce the rate of increase of the new CPI by subtracting a percentage of the inherited upward bias each month over some period, say two years. This would also be the fair thing to do, given the upside risk now facing users in any quick move to a rental equivalence measure. If a decision is made to make both CPI changes simultaneously in 1983, appropriate linkage is an absolute must, given these risks.

CPI FLAWS AND OVERPAYMENTS IN FEDERAL COST-OF-LIVING ADJUSTMENTS

Based upon recent experience, a solution to the homeownership problem would remove only 50% of the upward bias in CPI measurement of inflation. As Table Three shows, supply shocks and the substitution bias in the CPI have had a greater impact on the CPI since 1979 than the homeownership bias.

The substitution bias in the CPI arises from not adjusting the market basket of sampled goods for shifts in buying patterns due to changes in prices. For example, an increase in the price of lettuce will lead consumers to substitute spinach or fruit in their salads, so their cost-of-living does not increase. The CPI does not take this into account. In essence, it makes a false claim that the increase in lettuce prices has increased the cost-of-living for consumers.

TABLE THREE

Flaws in the Use of the Consumer Price Index for COLAs

	1978	1979	1980	1981*
CPI-U	7.7	11.3	13.5	10.5
homeownership bias	1.2	1.7	2.3	0.8
substitution bias	0.1	0.4	0.4	N/A
supply shocks	0.2	2.8	2.0	1.1
quality/regulatory factors	N/A	N/A	N/A	N/A
Pure inflation	6.2	6.4	8.8	8.6**

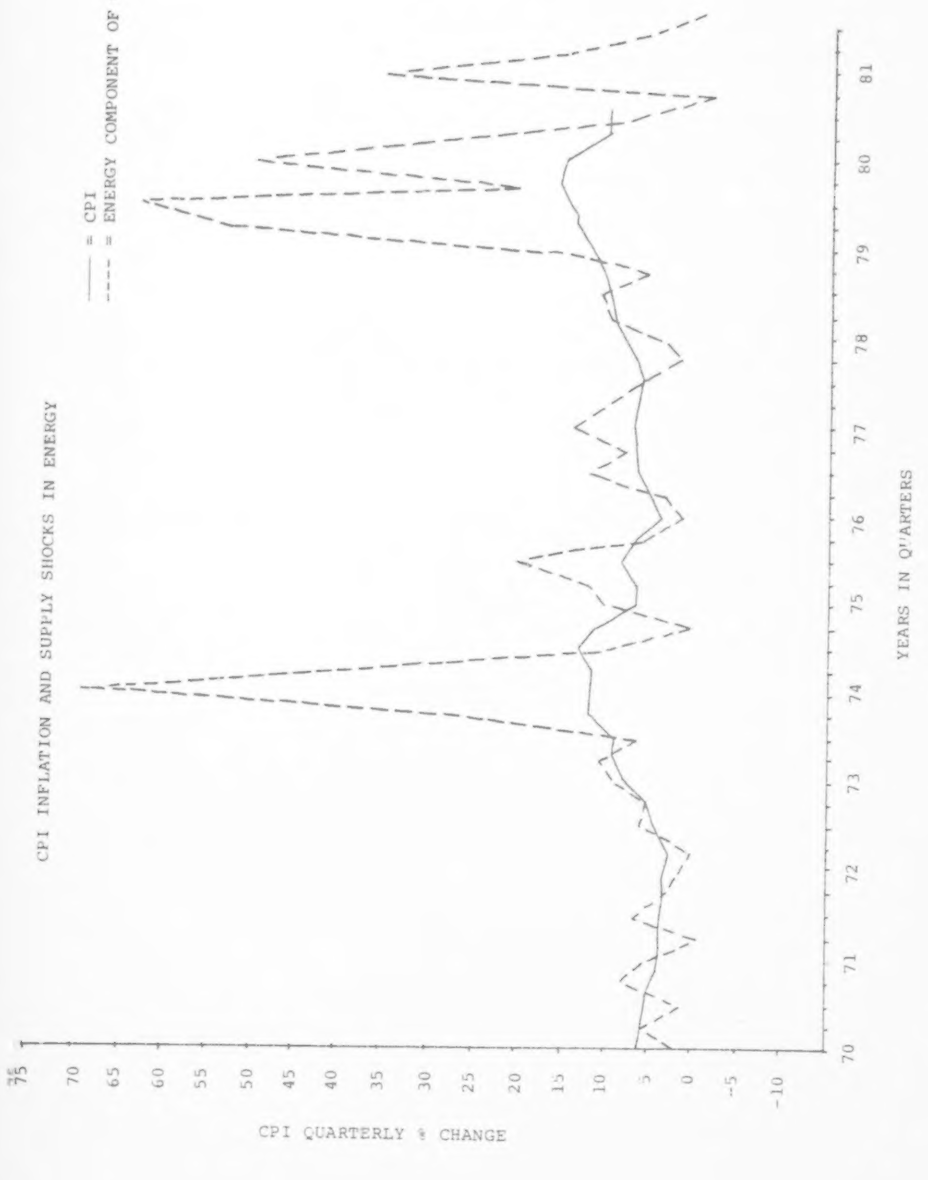
+ all numbers at annual percentage rates
* through October, 1981, by comparison with 1980, first 10 months
** assumes zero substitution bias

SOURCE: Economic Policy Division, Chamber of Commerce of the United States

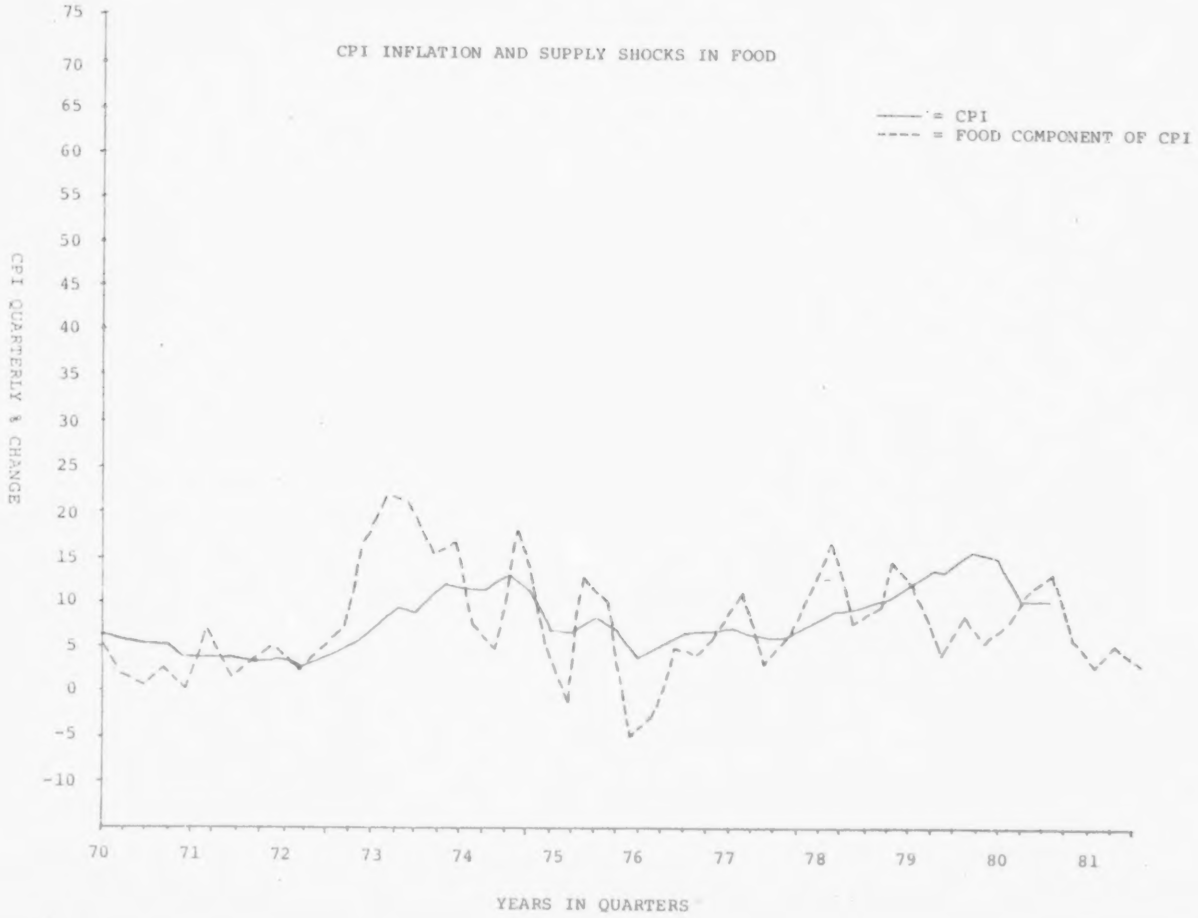
The substitution bias in the CPI is "small", and is not viewed as a subject practical people should be concerned about. But small is a relative term here. A 0.4% error in the CPI in 1979 and 1980, when the overall CPI registered 13.3% and 12.4%, respectively, led to $1.8 billion in unwarranted federal spending. The same bias, if it existed from 1978 to 1980 in the private sector, cost American business almost $1 billion in excessive COLA payments. Many experts believe the 0.4% estimate is too small.

With regard to supply shocks, the issue is not whether these price increases represent inflation or not. Clearly, any price increase is an increase in the cost of living. The issue is, what increases in the cost of living can we reasonably be expected to protect people against? Price increases generated by excessive monetary growth (demand inflation) can in principle be neutralized by indexation, leving everyone as well off as before. Price increases caused by crop failures or a rise in foreign oil prices (supply inflation) represent a real loss of national income. COLAs which include such price increases do not protect against the loss of national income. They can only protect an indexed group at the expense of non-indexed segments of the population, who have to absorb the entire real income loss.

Figure One shows the record of demand inflation and price shocks. In the 1970s shocks were concentrated in the food and energy sectors.



CPI INFLATION AND SUPPLY SHOCKS IN ENERGY


CPI INFLATION AND SUPPLY SHOCKS IN FOOD
—— = CPI
---- = FOOD COMPONENT OF CPI
CPI QUARTERLY % CHANGE
75
70
65
60
55
50
45
40
35
30
25
20
15
10
5
0
-5
-10
70
71
72
73
74
75
76
77
78
79
80
81
YEARS IN QUARTERS

At the moment, supply shocks are working to keep the CPI below the demand rate of inflation. In the fourth quarter of 1981, CPI-U was running at an annual rate of 5.3% while the demand rate was 8.1%, whereas in the third quarter CPI-U was 13.5% and the demand rate was 9.8%.

Economic theory has shown beyond a shadow of a doubt that a CPI type measure of inflation "over-indexes" in the long-run in the presence of real income shocks that take the form of, or lead to, price increases. The practical difficulty has been in trying to figure out how to factor supply shocks out of a price index. We cannot know ex ante when they will occur, where they will occur, or what their magnitude will be. The political difficulty has been a lack of public awareness about the severe problems associated with indexing for supply shocks: budget uncontrollability, higher unemployment, and failure of the price to clear markets properly.

One-hundred years ago the problem associated with indexing for supply shocks would not have existed. The burden of a crop failure would have been shared by the three generations living on the family farm -- the working generation, its children, and the retired parents of a son or daughter. But with our complex, highly specialized economy, support for the retired is now conducted indirectly through taxation of their working children and that support is adjusted for every price increase, even those that are due to declines in real income. As a result, the burden of that crop failure falls entirely on the working generation today.

Experts have considered two approaches to eliminating supply shocks from COLA agreements: 1) index splitting; 2) negotiation on an as-needed basis. Index splitting involves the creation of a so-called underlying measure of inflation which factors out supply shocks from a general price index. This is difficult to do, and up to now has been accomplished by excluding the energy and food components from the CPI. A COLA based on this index would still compensate for energy and food price increases, but only as these filter into the prices of other items in the index. Even so, such a procedure is open to the political charge that necessities are being excluded from the price index.

The alternative to an "automatic" system of factoring out of a COLA price increases due to supply shocks is negotiation, either at the collective bargaining table or in annual budget deliberations in the Congress. Because of the sporadic nature and magnitude of supply shocks, this method has much to recommend it, but it does depend upon a political acceptance of economists' judgement that indexing for supply shocks is inequitable and inefficient, adds to unemployment and hinders the market clearing role of the price mechanism.

EQUITY CONSIDERATIONS IN A FREEZE ON FEDERAL COLAS

Congress has deliberated long and hard in budget negotiations this year on the issue of freezing federal COLAs and/or paying a COLA at a fraction of CPI rather than a full CPI. A COLA freeze has emerged as part of Congressional "deficit reduction packages" that go beyond the five part deficit reduction plan in the President's budget.

The deficit emergency appears to be the only real justification for the tax and defense proposals. By contrast the economic merit of a COLA freeze can be argued on grounds of equity and fairness alone, quite apart from *any* other deficit reduction proposal. COLAs are much greater for federal transfer payments than for wages and salaries, and recent federal COLAs have over-compensated recipients because of serious flaws in the Consumer Price Index (CPI).

The Congressional Budget Office (CBO) lists 44 federal programs whose benefits are automatically programmed to increase with inflation, generally as measured by the Consumer Price Index. Together, these programs constitute over 30 percent of total federal spending. In the past three years COLAs alone have increased spending on these programs by 40 percent.

Most federal COLAs compensate *fully* for increases in the Consumer Price Index, while COLAs in collective bargaining agreements average about 58 percent of the CPI. Less than four percent of private pensions have automatic COLAs. The vast majority of working citizens have no automatic COLA at all. BLS reports that 5.1 million employees in major collective bargaining agreements were covered by COLAs in 1981, about five percent of total civilian employment. There is, of course, some inflation premium built into the market apart from formal COLAs and the BLS data do not cover all workers, but these factors do not change the general picture.

Largely because of this fundamental inequality in COLA protection, wages and salaries of working citizens have increased more slowly since the early 1970s than indexed transfer payments of which Social Security is the largest. With increases in each of the past three years, Social Security withholding taxes are now as high as the federal income tax for the typical working citizen. These ever higher taxes are not being put into "trust" for the young when they retire, but are being paid out immediately to retired persons as a result of uncapped growth in their per capita benefits.

As a result of these inequities, permanent modificiations to federal COLA formulas have been surfacing since 1979. Indexing federal transfer payments to the lesser of the rise in the CPI or average wages has been proposed as re-establishing equity in income growth between working citizens and transfer payment recipients. This proposal has now lost steam because it would contribute little to budgetary savings in the out-years, where wages are now forecast to increase faster than prices. Even so, the "lesser of" proposal is based on a misunderstanding of the equity issue, which is one of comparability in COLA protection, not comparability in income growth. Such wage indexing would freeze the distribution of income between different segments of the population. For markets to operate efficiently, wages and salaries must be free to fluctuate up or down in response to changes in productivity, shifts in the demand for skills or the relative prices of capital, labor, and resources.

The spotlight for permanent COLA reform in the federal budget is now on CPI minus three percent, which would save considerably more money than the "lesser of" proposal while addressing in some fashion the equity problem. A straight percentage of CPI, such as CBO's two-thirds of CPI proposal, or 60 percent of CPI, would probably generate greater equity with private sector COLAs in the long run, however. Different inflation rates would not lead to wide swings in degree of protection with a percentage cap as would CPI minus three percent.

A temporary freeze on federal COLAs has been proposed as an alternative to a permanent modification of the indexing formula this year. The political climate of an election year and the added weight of the President's bi-partisan Commission on Social Security Reform, which is due to report in December, are the main reasons for the shift in focus.

Aside from "equity in fiscal restraint", what is the economic rationale for such a freeze? One rationale would be to correct the income transfers of the past few years that are due to inequities in COLA protection.

But there is a second, less well understood equity issue that in and of itself would fully justify a one year freeze on federal COLAs -- overpayments for increases in the cost-of-living made recently because of flaws in the CPI.

Using a measure of underlying inflation supplied by BLS which "nets out" supply shocks and the homeownership problem and adjusting this for the substitution bias, we estimate that $21 billion in excessive federal COLA payments have been made since 1978. That figure, which was calculated last November, is by pure coincidence almost exactly the amount that would be saved by a freeze on federal COLAs for one year, starting July 1.

The primary stumbling block to a freeze on federal COLAs is the widespread myth that everyone over 65 is poor and needy. In 1980, 15.7 percent of the elderly were officially classified as below the poverty line, less than half the 1959 figure of 35.2 percent, and about the same as the 13 percent incidence of poverty among the general population. These poverty figures are based on before-tax income and do not reflect the substantial non-cash benefits received by retired persons which make up over 23 percent of their total income.

If after-tax incomes are compared and in-kind transfer payments are added to money incomes, the incidence of poverty is almost twice as high for those under 65 as for those over 65 (7.6% vs. 4.1%) according to a recent CBO study. This study should be updated beyond 1976 data because it has been in the past three years that inequities in COLA protection have caused the greatest disparities in income growth between working citizens and the retired. A just released Census Bureau study using 1979 data shows the same pattern.

Discretionary programs benefiting millions of Americans are being squeezed again in the President's budget because, as in 1981, that is the political path of least resistance. Against this backdrop, members of Congress are proposing new legislation for the aged this year.

Whether federal COLAs will be frozen or not for a year is still an open political question, despite recent evidence of wage and COLA concessions in collective bargaining agreements. Thirty-six million citizens receive Social Security benefits funded by 98 million working citizens of whom 68 million are under 45 years of age. If these 68 million wake up to the fact that they are being peppered to death with high interest rates caused in part by uncontrolled indexation, economic recovery may at last begin.

TESTIMONY OF DR. RUDOLPH OSWALD, DIRECTOR
DEPARTMENT OF ECONOMIC RESEARCH
AMERICAN FEDERATION OF LABOR AND CONGRESSIONAL ORGANIZATIONS
ON
THE CONSUMER PRICE INDEX AND AUTOMATIC COST OF LIVING ADJUSTMENTS
BEFORE THE
SUBCOMMITTEE ON CONGRESSIONAL OPERATIONS AND OVERSIGHT,
SENATE COMMITTEE ON GOVERNMENTAL AFFAIRS

April 20, 1982

Mr. Chairman, thank you for this opportunity to appear before your subcommittee to discuss the Consumer Price Index and its use for automatic cost of living adjustments.

In particular I understand you would find it useful if I would discuss the question of using CPI-U instead of CPI-W in government benefit programs and also the question of developing a special CPI for retired persons.

At present, of course, payments for social security beneficiaries and retirees under other government systems, such as those for the civil service and the military, are escalated in accordance with changes in CPI-W. Various bills have been introduced in the past to accomplish a transfer to the use of CPI-U instead, dating back to 1978 when CPI-U was first published. These bills obviously predated the complications recently introduced by the prospective change in the homeownership component announced by the Commissioner of Labor Statistics on October 27, 1981. The original rationale for the changeover was quite simply that CPI-U was a better index to use because the retired population was included in the expenditure surveys from which the Index was derived. CPI-W on the other hand, covers only the working population of wage earners and clerical workers.

We expressed the hope that a suitable index would be developed to represent the retired or aged population for whom inflation has different impacts than for either the population in general or for wage earners and clerical workers in particular.

Let me enlarge on the reasons why CPI-U does not really represent the buying patterns of the retired population any better than CPI-W. CPI-W excludes the expenditures of this population, but CPI-U drowns them out. Expenditures of families headed by persons age 65 and over make up only a small portion of total family expenditures -- less than 12 percent, according to data from the Consumer Expenditure Survey of 1972-73 conducted by the Bureau of Labor Statistics. Data from the same survey show that there is a distinct difference between the type of expenditures made by families with heads age 65 and over as compared with the population as a whole.

I am attaching a table illustrating this point. It shows the distribution of consumption expenditures for both groups as drawn from the Survey. We have adjusted the figures only to the extent of indicating the cost of home purchase and contracted mortgage interest on the basis used in the present Consumer Price Index. [1] Home purchase outlays, it will be noted, made up 10.9 percent of expenditures by the general population, but only 4.3 percent for families with heads age 65 and over. Similarly, mortgage interest costs were 5.2 percent for all families, but only 1.7 percent at age 65 and over. In marked contrast to the general population, most older families have already bought their homes and are no longer incurring mortgage interest payments.

[1] Home purchase and contract mortgage interest costs as used in the CPI are not directly presented in the published survey. We have, therefore, used estimates prepared by Social Security Administration analysts for an article in the Social Security Bulletin, January 1981 (Benjamin Bridges, Jr. and Michael D. Packard, "Price and Income Changes for the Elderly").

On the other hand, property taxes, insurance, maintenance and repair loomed larger in the expenses of older people. Taken together they comprised 7.7 percent of outlays as against 4.7 percent for the general population.

Other significant differences included shares of the older people's market basket going for food (21.0 percent as against 17.4 percent), for fuel and utilities (9.1 percent as against 6.2 percent) and for medical care (9.9 percent as against 5.5 percent).

Data of this kind led us to the conclusion that a special index for the aged is to be preferred to either CPI-W or CPI-U as a basis for adjusting social security and other retirement benefits. We would support Congressional initiatives to accomplish this result, including the necessary funding for the Bureau of Labor Statistics to undertake the work.

Apart from the matter of a special index, the question of using CPI-U vs. CPI-W for government benefit program has now been complicated by the announced change in the homeownership component of both indexes, but with different effective dates. For CPI-U the change takes place as of January 1983 and for CPI-W, the date is January 1985.

The change is a major one and is one that we have opposed for at least the last 20 years. What the change does is to drop the direct pricing of home purchase and mortgage interest costs along with property taxes, insurance and maintenance and repair. These specific homeownership cost indexes would be replaced by a price index for rental housing, as is done in the present "experimental" index, CPI-U (x-1). Rents would simply be substituted for direct homeownership costs.

We are deeply disturbed by the departure from the principle of direct costing of items being priced that people actually buy. If houses are bought and mortgages taken out, it seems to us a mistake to pretend they are rented. Most houses in the United States are in fact owned and not rented. This is especially true for the aged. The 1972-73 Consumer Expenditure Survey showed that two-thirds of the aged owned their homes, with 57 percent owning free and clear.

One of the basic issues in the long-term debate over the use of "rental equivalence" as a measure of homeownership costs has been the point that the owned housing supply fundamentally differs from the rental housing supply. Most rental housing is apartment housing and differs in its characteristics such as size, location, age of structure and type of occupants. Rental housing often comes under rent controls, while owned housing does not. And the American dream of owning a home, with its special costs, cares, and benefits, is hardly captured in a rental equivalence measure.

The problem of finding enough rental housing sufficiently similar to owned housing to serve as the basis for a rental equivalence index has been a sticky one even for proponents of this methodology. We do not believe it has really been resolved by the procedures being adopted by the Bureau of Labor Statistics, as outlined in its announcement of October 27, particularly for the "first stage" of the changeover scheduled for completion by January 1983. As of that date, the rental equivalence measure will have been only "half baked." Completion of the changeover is not scheduled until shortly before January 1985. This situation is in itself strong reason to oppose accelerating the effective conversion date of the CPI-W to January 1983. It also supplies reason to postpone the effective date for CPI-U to January 1985.

In the first stage of the changeover, all that will happen is that the existing rent sample, drawn to represent rental housing and not owned housing, will be rearranged to give more weight to rents in neighborhoods where the proportion of owned houses is largest and less weight to areas with the smallest proportions of owned houses.

In the second stage, BLS would enlarge the rental sample to include rents in areas in which the housing is "predominantly" owner-occupied, (obviously not a characteristic of the existing rental sample).

Dr. Geoffrey Moore, former Commissioner of Labor Statistics has commented on this sequence as follows:

> "The first part is relatively easy and inexpensive, but the second part is fundamental. Without it we shall really not know what is happening to rents for the typical owner-occupied home which is the basis for the whole scheme."

As labor representatives we of course have additional practical reasons for opposing any acceleration of the conversion schedule for CPI-W. Most labor contracts use CPI-W, with existing contracts expiring at various times between now and 1985. If a major alteration in the basic computation of the index is made, such as the housing change represents, it would invite disputes over the validity of existing cost-of-living adjustment (COLA) provisions. Some contracts specifically provide for renegotiation in such a case. Some provide for joint request to BLS to continue the computation of the old index for the remainder of the life of the contract. The possibly disruptive impact of basic CPI changes for existing agreements is in itself a sufficient reason not to install a rental equivalence CPI-W before January 1985.

In sum, Mr. Chairman, we favor the development of a special index for aged or retired beneficiaries which could be used for the escalation of benefit payments under government programs. We believe this is a better solution than using either of the existing official indexes. We think it is important for price indexes to reflect the actual types of costs incurred by populations with significant differences in their manner of living. Certainly the difference between the working population and the retired aged is significant and should be recognized in the construction of price indexes for use in government programs. Merely transferring beneficiaries to a rental equivalent index at the earliest possible date would smack strongly of an effort to reduce benefit outlays as speedily as possible without regard to the actual situation of those affected. We oppose an effective date for rental equivalence any earlier than January 1985 for either of the present indexes.

Distribution of Consumption Expenditures, 1972-73

(CPI Basis)

	All Families	Heads Age 65 +
Consumption Expenditures	$9,510	$5,125
Percent	100.0	100.0
Food	17.4	21.0
At home	12.1	16.2
Away from home	5.2	4.8
Alcohol	1.2	1.0
Shelter	27.4	21.5
Rent	6.0	6.9
Other Lodging	.7	.9
Homeownership	20.7	13.7
Home purchase	10.9	4.3
Contract mortgage interest	5.2	1.7
Property taxes	2.6	4.1
Property insurance	.6	.9
Maintenance & repair	1.5	2.7
Fuel & Utilities	6.2	9.1
Housekeeping Supplies	1.4	1.8
Housekeeping Services	1.4	2.5
Furnishings & Equipment	4.6	4.0
Apparel & Upkeep	6.8	5.7
Transportation	17.7	14.9
Private	16.5	13.1
Public	1.2	1.8
Medical Care	5.5	9.9
Entertainment	5.3	4.1
Other Goods & Services	5.1	4.5

SOURCE: BLS, Consumer Expenditure Survey, 1972-1973. Home purchase and contract interest supplied by Benjamin Bridges, Jr. and Michael D. Packard, authors of "Price and Income Changes for the Elderly," Social Security Bulletin, January 1981

Senator MATTINGLY. Our next witness is Mr. Havens, Assistant Comptroller General of the General Accounting Office.

GAO is currently doing a study on this. We hope Mr. Havens will be able to share with us today some of GAO's preliminary findings.

Let me say I appreciate the good work the GAO does for us. I am quite interested in hearing your testimony.

TESTIMONY OF HARRY S. HAVENS, ASSISTANT COMPTROLLER GENERAL, GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY ROBERT W. GRAMLING, GENERAL GOVERNMENT DIVISION, GROUP DIRECTOR, GAO, AND JAY CHERLOW, PROGRAM ANALYST DIVISION, SENIOR ECONOMIST, GAO

Mr. HAVENS. Thank you, Mr. Chairman.

First I would like to introduce my colleagues at the table with me.

On my left is Mr. Cherlow and on my right is Mr. Gramling. Both have been extensively involved in the work we have done.

We appreciate the opportunity to discuss our assessment of the need for a separate consumer price index for retirees and our views on how the indexation of Federal programs might be modified.

From time to time, it has been suggested that a separate price index be constructed for retirees and used, in lieu of the existing CPI, as the basis for adjusting benefits under the various Federal retirement programs. Some have argued that retirees have been inadequately compensated for increases in the cost of living, while others maintain that adjustments based on the CPI have been overly generous.

We undertook to test these arguments by constructing a CPI for retirees, using readily available data from the Bureau of Labor Statistics. We reweighted the expenditure and geographic data to reflect the consumption patterns and geographic distribution of the retired population. Using BLS's methodology for the CPI, we then recomputed the consumer price index for each of 39 months, starting with January 1978, and compared the resulting index with the existing CPI.

There are certain unavoidable technical limitations in the GAO-constructed CPI for retirees, but we believe it gives a reasonable approximation of how such an index would have behaved during the period covered by our review. Because it was already a matter of debate, we also decided to test the consequence of using a new method of calculating the housing component of the CPI. The results of this work and the details underlying it will be contained in a report which we expect to issue shortly. We will supply copies of the report to the committee as soon as it is published, but the main points can be summarized rather briefly.

We found no evidence that a separate CPI for retirees in the aggregate would have deviated markedly from the current CPI during the period covered by our review, once the treatment of housing in the CPI is corrected. In our view—a view which is widely shared—the current treatment of housing costs in the CPI has significantly exaggerated the measured rate of price increase in recent years.

BLS has decided to revise its way of computing housing costs. We agree with the need for that change. To all intents and purposes, making this change in the current CPI would eliminate the differences between that index and the one we constructed for retirees. Accordingly, we recommend against creating a separate price index for retirees.

We note, however, that BLS does not plan to make this change to the CPI-W—the index currently used to make adjustments in Federal retirement programs—until 1985, even though the data needed to make the change is expected to be available in January 1983. But, there is another available index, called the CPI-U. This one is based on the consumption patterns of all urban households, rather than being limited to urban wage earners and clerical workers, which is the population base of the CPI-W.

The broader population base of the CPI-U appears to make it better suited for use in indexing programs. A second advantage is that the housing component of the CPI-U will be corrected in 1983, 2 years earlier than for the CPI-W. In a report we issued in April 1981, entitled "Measurement of Homeownership Costs in the Consumer Price Index Should be Changed," (PAD-81-12) we recommended that Congress enact legislation requiring that the CPI-U be used, rather than CPI-W, for future cost-of-living adjustments in Federal retirement programs. The results of our recent study add further support to this view.

It is impossible to predict with confidence the budgetary effect of our recommendation. Such a prediction would entail forecasting future movements of specific components of the CPI. Such forecasts are notoriously difficult to make and unreliable. OMB has estimated that the change might increase outlays by $2 billion. There are other forecasts, however, which indicate that the costs would be negligible. To this we can only add that, if the change had been in effect during the period covered by our study, it would have reduced outlays in the four major Federal retirement programs by $13.8 billion.

To return, for a moment, to the question of a separate index for retirees, our conclusion that one is not needed now does not permanently foreclose the issue. Consumption patterns of retirees have certainly differed from those of the working population. And it is possible that future price changes would yield divergences greater than those we observed, although it would be highly speculative to predict whether or not this will occur, or in which direction any divergences might appear.

Because of this uncertainty, combined with the sheer size of the Federal retirement programs and their widespread effects, we believe it would be useful to monitor the situation through periodic updating of our work. We suggest that this be done by BLS, which is equipped to do so quite efficiently. If, in the future, a substantial divergence emerges, it might be worth reopening the question.

Thus far, we have been focusing on the technical adequacy of the CPI as a mechanism for adjusting Federal retirement benefits. Even if the changes we suggest are made, however, we believe the time has come to face a larger issue, the need to bring indexing as whole under control. I would like to turn, now, to a discussion of that issue.

We have testified on other occasions that some means of limiting the present indexing system is essential. This view is based on the following considerations:

One, explicitly indexed programs account for about one-third of the budget. To exclude from consideration the issue of indexation would unnecessarily limit the options available to the Congress as it seeks ways to constrain the budget.

Two, the actions necessary to reduce the deficit will require some sacrifice by most Americans. To continue insulating the benefits of one group would be inequitable and would increase the sacrifice required in other sectors.

Three, the indexation of entitlement programs has been a major factor in the growth of that portion of the budget which is uncontrollable in the short run. Constraints on indexation are, we believe, indispensable if the Congress and the President are to regain an increased measure of short-run control over the budget.

We issued a report on this subject in March 1981 entitled 'What Can Be Done to Check the Growth of Federal Entitlement and Indexed Spending?" (PAD-81-21). One option which we reviewed involves limiting the inflation adjustment to the level of the average increase in worker pay or the CPI, whichever is less. This alternative moves away from the exclusive use of a price index. The argument for making such a change is based on equity considerations. While, at present, income from indexed entitlement programs is protected against inflation, not all entitlement programs are indexed, and wage earners income is certainly not protected. The result is that in any period in which prices are rising more rapidly than wages, present formulas redistribute income in favor of the indexed groups—thus increasing the burden on wage earners. Using the lesser of a wage or price index would have wage earners and entitlement recipients share equally in the burdens imposed by falling real incomes.

This apparent equity during hard times, however, would not be balanced by equity during good times. Historically, wages have risen more rapidly than prices. If we return to that situation, the proposal would limit benefit increases to the rate of increase in the CPI. Thus beneficiaries would share in the burden of falling real incomes, but not in the benefits of rising real incomes. Such an unbalanced approach appears unfair. While saving money in the short run, it would also leave the indexing system unduly rigid and mechanistic. It does not restore the element of flexibility to the process which we believe is necessary to control and reduce the budget deficit.

The option we prefer for constraining the indexation process is to give the President and the Congress the discretion to modify, through the budget process, the amount of the adjustment indicated by the index. The President could be authorized to recommend a specific percentage adjustment to benefit levels that would take effect unless the Congress acted to change it. This is the same procedure now used to adjust Federal white collar pay. The President might also be authorized to use different rates of indexation at different benefit levels in order to mitigate adverse effects when conditions warrant. This approach would restore flexibility by permitting the President and the Congress each year to make decisions balancing budgetary considerations against the desire to maintain the real level of benefits.

That completes my prepared statement, Mr. Chairman. I will be happy to respond to any questions.

Senator MATTINGLY. Thank you very much, Mr. Havens. When did you say the report is going to be published?

Mr. HAVENS. I believe it is in final processing at this point. I would expect it within the next month to 6 weeks.

Senator MATTINGLY. The only question I would have to ask you, do you think the two CPI's should be changed at this time?

Mr. HAVENS. Well, we certainly agree with changing the CPI-U. As I have indicated we recommended shifting to the CPI-U as the base for indexing Federal retirement programs when the housing component is corrected in 1983. There is I think a legitimate concern that Commissioner Norwood expressed in the announcement in which she stated the BLS decision to change the housing component. Namely, there are a number of legal ramifications for changing the CPI-W, which would be a reasonable basis for delaying changing the housing component of CPI-W because of private sector consequences in doing so.

At the same time, we do believe that the altered treatment of homeownership in the housing component is an important change and should be reflected in the treatment of Federal programs as soon as possible.

Senator MATTINGLY. Do you agree this chart we have up here accurately describe the discrepancy you all were speaking about?

Mr. HAVENS. As I read it, and I am not familiar with the chart as such, but that would be a comparison of CPI-U to the average hourly earnings. So it would reflect the difference between the index, which we would recommend be used except it would be corrected for the housing component, and the wage earners index. The excess of the red line over the blue line would clearly indicate a period when the CPI was raising indexed benefits at a rate faster than wage earners income was rising.

Senator MATTINGLY. We got the information from CBO.

Mr. HAVENS. I would have no reason to doubt CBO's accuracy.

Senator MATTINGLY. There is a wide discrepancy you have been talking about. There it is, I guess, in blue and red. Thank you very much for coming. I appreciate it.

We are very fortunate to have today a distinguished panel of economists concerning the issues of the CPI, Dr. Leveson, Director of Economic Studies at the Hudson Institute in New York. He is joined by Dr. Minarik, formerly with the Brookings Institute, now Deputy Assistant Director, Tax Analysis for the CBO and Dr. Blinder, professor of economics, Princeton University.

The Brookings Institute has published a paper of Professor Blinder's on the CPI which I understand you will submit for the record today.

Welcome.

TESTIMONY OF IRVING F. LEVESON, DIRECTOR, ECONOMIC STUDIES, HUDSON INSTITUTE, CROTON-ON-HUDSON, N.Y.; AND JOSEPH J. MINARIK, DEPUTY ASSISTANT DIRECTOR, TAX ANALYSIS, CONGRESSIONAL BUDGET OFFICE, WASHINGTON, D.C., AND ALAN S. BLINDER, PROFESSOR OF ECONOMICS, PRINCETON UNIVERSITY, PRINCETON, N.J.

Mr. LEVESON. Good morning, Mr. Chairman.

My name is Irving Leveson, director of economic studies at the Hudson Institute. I am pleased to have an opportunity to discuss issues of indexing entitlement programs. I believe we have an important opportunity to make changes that will make a longlasting contribution to the way we handle these difficult issues.

Several problems can be converted into opportunities in restructuring the way benefits are indexed. A serious problem exists with any indexing because of the potential that inflation in one part of the economy will immediately, automatically, and completely lead to further inflation in another sector multiplying inflationary effects. I will suggest one way of avoiding this multiplication that can be combined a useful approach to indexing entitlement programs.

I will introduce the notion of negotiated indexing for dealing with these problems.

Indexing is essential for efficient operation of the economy in a climate of inflation. For entitlement programs it serves the critical function of setting a limit to the amount by which the purchasing power of beneficiaries can be reduced without explicit congressional action. But it does so at the risk of transmitting inflation rapidly from one part of the economy to the other.

There are important opportunities to introduce the indexing in forms which minimize the inflationary impact but still retain much of indexing's benefits. In private cost of living agreements, indexing is often incomplete. A typical agreement raises wages by formula for half of the increase in the price level and then allows the additional increases to be determined in collective bargaining. The use of bargaining exerts a brake on the transmission of inflation from one section to another. In the case of entitlement programs, no such brake exists.

Entitlement programs have been fully indexed to changes in cost of living. Omitting inflation, if inflation is less than 3 percent, is a device that only deals with administrative convenience and not with the much more important issue of the effects of indexing on the stability of the entire economic system.

A preferred approach, negotiated indexing, would index for, say, the first 5 percent of change in the cost of living. Further adjustments could be made by formula, for, say, half of the inflation above 5 percent. The Congress at its discretion could provide special adjustments from time to time to make up for additional cost of living changes, varying the timing and braking the link that makes the transmission at inflation to other sectors of the economy so complete and automatic.

I would like to suggest how to integrate this notion of negotiating the last part of the indexing with decisions about indexing on the basis of wages versus prices. The economic function of indexing on the basis of wages is to pass along productivity increases—which would occur through wage increases to people who are working—to those who receive income maintenance benefits.

Wage indexing, which is widespread throughout Europe, tends to overindex also because an important part of the productivity gains which are reflected in wage increases are the results of individual initiatives—such as individuals getting greater education—and these ought to lead to compensation directly to the individuals involved. But an important part of productivity gains are the result of general sources and ought to be shared among persons who are working and persons in entitlement programs as well.

In the long run, this means we ought to have some system which would compensate persons on entitlement programs for increases in wage levels perhaps to half of the difference between wage growth and the growth in the cost of living.

This notion of productivity sharing can be combined with the problems of adjustments which we have today. There are three separate issues in trying to set benefit levels. First we need a basic standard which reflects what society is willing to do. Then we need a way of adjusting benefit levels over time to take into account inflation. Today we face additional problems as a result of past overcompensation. Overcompensation has resulted from technical errors in the price indexes—including both the treatment of housing and the use of base per weights—from technical errors in the social security benefit formula, from the way we deal with impoverishing events such as the oil shock, and from not allowing for recent productivity declines.

While in the future we should share productivity gains, we have to deal in a practical way with an environment in which productivity has been declining. That can be done by deferring the special adjustments in a negotiated indexing system. Let me illustrate—assuming that the rate of inflation will be 8 percent and that the intent is to provide a special adjustment every 4 years The first 5 percent of inflation will be automatically indexed.

Half of the difference between 5 and 8 percent will be indexed so there will be increases of 6½ percent each year. If we forego increases for the additional half for the next 4 years in order to adjust for past overcompensation, the corrective adjustment would be 6 percent over the next 4 years. Now let's say that in the succeeding 4 years wage changes are 10 percent per year and we wanted to grant half of the difference between the price change of 8 percent and the wage change of 10 percent as a productivity-sharing benefit.

Well, in the next 4 years, we would be paying 6½ percent out of the 8-percent in inflation in regular cost of living adjustments. At the end of that 4-year period, we would make up the other 6 percent, the other half of the difference between 5 and 8, plus another 4 percent for productivity sharing. That would lead to a crossover point in 10 years at which time beneficiaries would be receiving as much as under current formulas indexed to the cost of living but without productivity sharing.

But before the end of that 10 years we would have a maior impact in adjusting for overcompensation and in dealing with the budgetary problems faced today. And in the long run, we would have an automatic system for sharing productivity gains with persons on otherwise fixed incomes.

This device has a nice advantage in that by only immediately indexing half of the inflation changes over 5 percent, it provides the kind of break that we need to avoid the rapid transmission of inflation during periods of economic stress.

Thank you.

Senator **Mattingly**. No doubt you agree the CPI, as it currently exists, is an inaccurate reflection of the rate of inflation.

Mr. **Leveson**. Yes.

Senator **Mattingly**. I know that you are also an authority on tax indexation. I supported the indexation provision we passed last year. What do you think would happen if we used that inaccurate measure? Do you think it would damage the effects of tax indexation?

Mr. **Leveson**. Just as the failure to index the tax system led to very severe bracket creep, which has created disincentive for the economy, overindexing will create the reverse problem in exacerbating our budget problems.

A more serious issue, I believe, is the fact that there are many billions of dollars in inflation premiums that we are taxing right now which the indexing system that was approved does not begin to deal with.

If inflation is 10 percent and interest is 15 percent, two-thirds of interest income is return of capital; it compensates you to avoid loss of purchasing power. Yet, you are taxed on the inflation premium as if it were ordinary income. If a dividend rate is less than the inflation rate, or corporate rate of return on equity is only equal to inflation, it is still taxed.

At the same time, we allow you to deduct interest when it includes the other fellow's return on capital—the inflation premium in his interest rate. So we have a system now which has a very severe bias against incomes on capital of all forms and at the same time encourages leveraging, which contributes to our capital market problems.

I believe we have just scratched the surface on what we need to do in taking inflation out of the tax system.

Senator **Mattingly**. I agree with the formula you have to apply now to index programs. You are advising that we couldn't use that same formula to apply to tax indexation; is that correct? If not, what would you use?

Mr. **Leveson**. I would do it differently. We are currently doing a study of alternative tax systems for Citizens Choice and the Chamber of Commerce of the United States. We are looking at a variety of devices, including elimination of the corporate profits tax, eliminating the inflation premiums before you count how much income is subject to tax, and shifting from an income to a consumption tax.

A consumption tax has the advantage of not taxing inflation premiums because you could only have consumed income if it was real income in the first place.

Senator **Mattingly**. I would like to ask Mr. Blinder and Mr. Minarik the same question.

Mr. **Blinder**. I think it would probably be a mistake, given the objectives of tax indexing, to index to an index that has wages in it.

The object is really to make the tax system inflation neutral, as Mr. Leveson just said. It is only a small step in that direction. The index should be of prices only.

Mr. **Minarik**. I agree with Alan that the appropriate choice of an index for taxing indexation would be an index of prices rather than wages. I think there are very serious questions that have to be asked about whether, in fact, we want to index at all, and if we do, to what extent we would go into the tax system and change it. We do have, everyone would agree right now, Mr. Chairman, a budgetary crisis. The indexing provision that takes effect in 1985 does cost us a great deal of revenue.

If we have to go back to the beginning and start thinking about how we are going to narrow this budget gap, and if we do decide that part of the narrowing of that gap has to come on the tax side, it seems to me reasonable that indexing as well as all the other tools we have at our disposal should be under consideration.

Mr. **Leveson**. I would like to make clear I do believe we index with prices, not wages, but I think in the long run we will need some form of productivity sharing that is clearly not appropriate at a time when we are trying to make adjustments for overcompensation.

The approach I use to encourage discussion on this point is a way of phasing it in and only as the economy can afford it.

Senator **Mattingly**. I want the other two to summarize a little bit. But I would like to ask you one question.

You mentioned indexing of cost revenues. I guess I would disagree. I don't think they are cost revenues. The Government has been robbing the people by the system, by the bracket creep, so to speak. Some of us believe indexing prevents that. It just doesn't get the revenue it was taking under a disguise, to say the least.

Mr. **Minarik**. That is certainly a reasonable argument, Mr. Chairman. I would only suggest a couple of things. One way to deal with that problem is to index the brackets and personal exemption which is what we have done.

Another way of reducing the inflation sensitivity of the tax system while not purely eliminating that bracket creep effect would be a tax rate schedule that was generally lower and flatter than the current system now is.

The degree of overtaxation is a function of the height of the marginal tax rates; the lower the tax rates are, the less the overtaxation is.

Another thing is that Mr. Leveson is suggesting a tax indexation system which is more elaborate than we have. What we have done in the law is to index the brackets and the exemptions. One could go on farther in dealing with inflation in the tax system by taxing only real interest, for example, as opposed to nominal interest, taxing only real capital gains as opposed to nominal capital gains, or what is referred to as tax base indexing.

If someone held a 10-percent bond over a year in which there was 10-percent inflation, that person's income for tax purposes would be zero because his interest precisely offset the depreciation of the principal amount of his bond.

That system of indexation has a lot of very nice properties with respect to treating people neutrally with inflation, but it can be devilishly complex for the taxpayer. It really requires indexing every quantity in the tax system from top to bottom, which means homeowners would be paying tax to the extent that inflation depreciated the principal amount of their mortgages.

If you in fact didn't tax the depreciation of debt while you were giving deduction for the depreciation of assets, you would be allowing tax sheltering possibilities that would allow anyone with minimal means to avoid paying income taxes in perpetuity.

Senator MATTINGLY. I will let you summarize your statements. I will say some people believe the tax systems are already complicated enough.

Mr. LEVESON. I do want to point out the whole reason for looking at alternative tax systems, is there are approaches that can accomplish 80 or 90 percent of the designed results without adding complexity and perhaps even enduring it.

Senator MATTINGLY. Mr. Blinder?

Mr. BLINDER. I would like to address a few points. You have heard so much testimony this morning that I will try to be brief and try not to repeat things that have been discussed.

There are many proposals to reduce indexing, but I would like to begin by spending a few minutes on the basic reasons why we index and, in fact, defend these reasons, arguing that they are very good reasons.

Then I would like to suggest, contrary to many statements I have heard and read in the press, that indexing is not to blame for our current and impending budgetary problems. And then I would like to briefly touch on a couple of proposals for indexing and, finally, if there are questions, maybe we will come back to the consumer price index. But I have a feeling that was covered as much as need be.

There are two basic reasons why private parties, such as workers and management, enter into index contractual agreements. These reasons apply just as well between contractual agreements between private citizens and the Government.

The first reason is because inflation is unpredictable; unindexed contracts expose people to risks that could be removed by writing indexing into the contract.

For example, if a company believes inflation will be 8 percent and agrees to pay its workers a 10-percent increase, it is planning to pay a 2-percent real increase, but if inflation turns out to be 10 percent, it will have paid no real increase, whereas if it turns out to be 6 percent, it pays a 4-percent real increase.

The case with government transfer payments is exactly analogous. An 8-percent increase in social security benefits will maintain the purchasing power of benefits, if inflation is 8 percent. It will cut them, if inflation exceeds 8 percent. It will raise them, if inflation is less than 8 percent. If you believe, as I certainly do, that the Congress, and not the inflation rate, should be deciding how generous social security benefits should be, then it makes good sense to index these benefits. That is, in fact, what has been done.

A second and quite different reason for indexing is to correct certain serious distortions of economic decisionmaking that inflation might otherwise cause. But quite simply, the objective here is to enable the economy to function with inflation exactly as it would have functioned without inflation.

I think the case of taxing interest income has been brought up already and I think it makes the clearest example. If you can turn to the testimony on page 3, I put in a table that shows in the first column the taxation of interest income when there is no inflation.

I took the case of a $1,000 bond with a 4-percent interest rate earning the holder $40 of interest, all of it real interest, all of it taxed.

I assumed a 40-percent tax rate. He paid $16. The corporation who issued this bond would get a $40 tax deduction. If inflation went up from zero to 4 percent, and a 4-percent real interest rate prevailed on the bond, the nominal interest paid by the corporation would go up to $140. Only $40 of that is real interest, $100 is compensation for inflation. But the taxpayer would be taxed on the whole $140 and, if he was paying a 40 percent tax, pay $56 in tax, which exceeds the income he earned. He only earned $40 in real income.

Some people would argue that is an overtaxation.

The flip side of that, of course, is that the corporation gets an excessively large tax deduction for the interest that it pays. It pays 140 nominal dollars but $100 of that is really returned principal. Only $40 is real interest, but yet it gets to deduct the whole $140.

The upshot of all of this is that with the tax system not indexed—and in this respect, of course, it is not indexed today—a rising inflation rate raises the tax on interest earnings and raises the subsidy given to borrowing.

And many economists, including myself, view this as a serious problem. This is a problem, I should add, that can be fixed up by indexing. If, in fact, the tax code were rewritten so that only the real interest were taxable and only the real interest were tax deductible to the corporation, you would get the numbers that are given in column 3 of the table which basically restores the tax burden on the interest recipient and the tax break for the interest payer to what they would have been if there was no inflation.

That is the point I was trying to make. The object here is to immunize the economy against inflation.

I submit that these two purposes, first of all, reducing inflation risks that otherwise certain parties such as social security recipients and others would be subject to, and eliminating inflationary distortions are very important purposes, and in fact what we need in the Government budget is not less indexing but more indexing.

How do I square this with the widespread view that indexing is partly to blame for our budgetary problem?

My answer is simple. I think the charge is wrong, that indexing is innocent. What indexing does is nake automatic the periodic adjustments in benefits and taxes that Congress more than likely would make in any event.

Over fairly long periods of time, it doesn't matter if things are indexed or not. Because de facto they will be indexed.

Social security is a very good case. Until 1975, social security benefits were not indexed. We did have inflation before 1975. It is not the case, except for some short periods of time, that social security benefits were eroded by inflation. The reason is quite simple.

The Congress wouldn't let it happen and periodically raised nominal benefits. The object of indexing, then, is not to change the trend rate of growth of social security benefits in either direction, but simply to make automatic and smoother what Congress was doing periodically and less smoothly right along.

We were speaking a minute ago about the income tax brackets. We can think of bracket creep in exactly the same way. If you look at table 2 that is on page 5 of my testimony, it records the percentage of personal income taken by Federal personal taxes, and there are two interesting things to note on that table.

First in the bottom part, you will note that between 1952 right up to about 1977 or 1978, there was just no trend in that number. Brackets were not indexed. What was happening, of course, is that inflation would cause bracket creep and every few years Congress would enact a tax cut to get rid of the effect of bracket creep. So taxes would creep up and Congress would beat them down, and there really wasn't any trend.

That's quite a contrast to what happened. Roughly during the 4 years of the Carter administration, when there was a lot of inflation, there was very little personal income tax cutting. The ratio rose from 11.1 percent to 12.3 percent. That may not look like very much, but it's a huge number by historical standards and in fact helped precipitate a taxpayer revolt.

This is something that would not have happened had there been indexing. I am not sure to what we should attribute to it: to the President forgetting, to Congress forgetting. Somebody forgot and there was bracket creep. It turned out to be important. It wouldn't have happened with indexing.

So the tax bracket example indicates the same point as the social security example. One shouldn't think of indexing as changing the longrun trends in either taxes or benefit programs, but what you should think of indexing as doing is eliminating a lot of the shortrun gyrations and risks that are generated by inflation in an unindexed tax system. That is why I think many economists think indexing is a good idea.

Several ways of limiting indexing have been mentioned here this morning. One of them is a cap, a proposal to, say, limit indexing to the first 5 percent, or someone said earlier 4 percent of inflation.

If we take social security again, beneficiaries we are protected against inflation up to 5 percent but afterward they are not protected at all. What that would do, if inflation stays above 5 percent, which seems a plausible forecast, is tantamount to a decision to raise nominal benefits by 5 percent a year and get rid of indexing entirely.

It would, therefore, put back into the system all the inflation risks that could have been successfully eliminated by Congress, except for the problems of the index which we talked about this morning.

In principle, these risks could have been successfully removed by the 1972 legislation. So I don't find that a very attractive proposal

Another proposal that has been much discussed is indexing benefits to the minimum of price inflation or wage inflation, whichever is lower. This proposal would index benefits just as at present if wages grow faster than prices, which has been the historic norm, but would reduce benefits any time prices grew faster than wages, as has happened several times in the recent years.

One thing to notice is that it would still leave the beneficiaries of social security benefits subject to the inflation risks that I mentioned at the outset. And it also tends to drag down benefits. They would go down in real terms when prices rose too high. There is no mechanism to raise them.

I imagine what would happen is that Congress would start to do just what it did in the preindexing days and legislate periodic increases in benefits to make up for that.

Finally, a proposal has been made to index above some minimum amount. This is just the opposite of a cap. For example, Martin Feldstein has recently proposed that social security benefits be adjusted by inflation minus 2 percent. As I said, this is the opposite of a cap. It does, in fact, provide protection against inflation risks, which was the original object of indexing. What it does is lower benefits by 2 percent a year. The right way to think of that proposal is really having nothing to do with indexing but being a policy decision to reduce social security benefits by 2 percent a year. That may be attractive or unattractive. Really it doesn't have anything to do with indexing.

The rest of my testimony has to do with the Consumer Price Index. I think in the interest of not repeating what was already said, I won't read that unless you have some questions.

Senator **Mattingly**. We will make that a part of the record.

Mr. Minarik.

Mr. **Minarik**. Thank you, Mr. Chairman, I think I would like to attempt to achieve brevity by cutting out some portions of my prepared statement. It probably won't come as too much of a surprise, but I am going to agree with my boss, Alice Rivlin——

Senator **Mattingly**. We will make sure she gets that memo.

Mr. **Minarik**. On the problems with the Consumer Price Indexes and the need to change over to the rental equivalence measure of owner-occupied housing. I would like to say just one thing, though, about the timeliness of switching over to a revised Consumer Price Index. As Dr. Rivlin and a number of others before this panel have suggested, depending on the movement of mortgage interest rates and home prices, it is possible that an early changeover to a rental equivalence price index will, in fact, increase outlays in the shortrun. In other words, if interest rates fall and home prices fall, the CPI, as currently constituted, would increase less rapidly than the revised Consumer Price Index.

However, I would like to point out that we may want to consider making a changeover to the revised CPI early. It does have some merits. The worst possible contingency for the indexed Federal programs would be a shock to the economy causing higher interest rates and unemployment while the current CPI is in use. In that event, indexed outlays would increase sharply because of the CPI's flawed treatment of homeownership, and Federal income and payroll taxes would be reduced at the same time. It would be a double whammy of higher interest rates and, therefore, more rapid increase in the current CPI, and more rapid increases in indexed outlays, and we would expect such a shock to the economy to reduce employment and incomes and, therefore, reduce Federal revenues.

On the other hand, if we implement the revised CPI at the earliest possible date, we at least minimize the bulge in indexed outlays which would occur in this worst case scenario. The shortrun forecast for the economy is generally for falling interest rates. As I point out in my prepared testimony, the shortrun forecast for the economy has been for falling interest rates for the last 15 years. It hasn't happened yet. We might want to prepare ourselves for the worst by switching over to a reconstituted CPI at the earliest possible date to protect ourselves against the worse possible outcome, and consider that if interest rates do in fact fall and we do in fact lose a little bit of the benefit that we would have gotten under the current CPI with falling interest rates, what we are doing is paying for insurance against the worst possible outcome.

I have some remarks on the special group price index issue which I think I would like to make even though this topic has been discussed somewhat up to this point. Construction of the new price index for some special subgroup of the population, in particular the elderly, would be extremely costly and time consuming. We should, therefore, proceed if, and only if, there is some solid evidence that the new index would depart significantly from the current CPI and if we are to put the new index to use in some Federal Government program.

It is not at all clear that either of these two conditions is met. First, the evidence on the rate of inflation in the market basket of the elderly, relative to that of the general population, is extremely sketchy. The work that has been done in this area suggests that the divergence between the inflation rate faced by the elderly and that of the population at large, if there is any divergence at all, is very small.

Second, there is a real question as to whether such a price index for the elderly should be used. Some analysts believe that a price index for the elderly would show that that subpopulation faces more rapid inflation, and thus would justify greater indexation of social security benefits.

Unfortunately, while more rapid inflation in an elderly price index might lend intellectual support to greater indexation, it would not pay for it, and the social security system is in rough financial waters as it is. Other analysts believe that an elderly index would increase more slowly than the CPI, and thus justify a cutback in indexation. This group might think again about the inevitable controversy involved in indexing social security at a rate less than the general rate of inflation, by which many other programs are indexed. And both groups might consider how we would treat the almost one-third of social security beneficiaries who are not elderly, and the chaos that would arise if we tried to index different beneficiaries by different indexes.

An alternative proposal would be to create an elderly price index on an experimental basis, using the current CPI with slightly altered weights as a basis, merely to observe its behavior relative to the index for all urban consumers. This proposal seems harmless enough, but it has dangers of its own. Such an experimental index would differ significantly from an actual price index for the elderly, begging many important statistical questions. The current CPI is not designed to represent the geographical location of the elderly, or the stores at which they choose to shop; rather, it reflects those patterns for the entire urban population, which may be different from those of the elderly.

As a result, extreme controversy would be sure to follow the release of an experimental elderly price index based on the CPI. If it differed from the general index, one group of analysts would praise it and demand that it be made official, while others would attack it for its conceptual flaws. On the other hand, if the experimental elderly price index did not differ from the CPI, then both groups would argue that the experimental index was flawed. In the final analysis, we would have learned nothing.

If we wish to learn more about the effects of inflation on the elderly, we should consider the merits of some basic research: Where do the elderly shop? How do prices change at those outlets, as opposed to the outlets frequented by the population at large? How have public and private insurance affected the medical care costs of the elderly? Answers to these questions will be needed to assess the importance of, and to construct, a price index for the elderly.

That concludes my statement, Mr. Chairman.

Senator **MATTINGLY**. Thank you very much. One statement to everybody. Do you agree then the CPI, as it currently exists is an inaccurate measure of the rate of inflation?

Mr. **LEVESON**. I believe it is inaccurate and should be changed at the earliest possible date, and not get into guessing games about the path of the economy, and not take the risk of losing the political opportunity to make the change.

Mr. **BLINDER**. I agree with that.

Mr. **MINARIK**. Ditto.

Senator **MATTINGLY**. Bring all that together and get three economists to agree at one time on that is fantastic and I don't think I am going to test anything else. I appreciate you all coming and testifying. I am familiar with your work and as the balance of this committee will be familiar.

Thank you very much.

[The prepared statements of Messrs. Leveson, Minarik, and Blinder follow:]

PREPARED STATEMENT OF IRVING LEVESON

An appropriately designed indexing system can both assure beneficiaries continuity of a basic level of income and insulate the economy from some of the magnifying effects of indexing on inflation. There is a strong case for negotiated indexing and for combining a negotiated approach with a system to pass productivity gains along to beneficiaries.

Indexing is essential for the efficient operation of the economy in a climate of high inflation. For entitlement programs, indexing serves the critical function of setting a limit to the amount by which the purchasing power of beneficiaries can be reduced without explicit Congressional action. Indexing carries with it a risk, however, that inflation will be magnified as price changes in one part of the economy are immediately and automatically transmitted to the indexed sectors.

Much of the economy is already indexed through private actions. Thus, the choice is not whether a fully indexed economy is too inflation prone compared to an unindexed economy, but rather whether additional indexing under consideration provides gains which outweigh potential risks. In some areas of economy activity, particularly taxation and the structure of financial instruments, indexing too limited to deal with the large effects of inflation on the entire economic system. The need to continue much of the indexing that already exists and to extend indexing where it could provide substantial gains, creates a special challenge. Important opportunities exist for introducing forms of indexing which minimize inflationary impacts while still retaining much of its benefits.

In COLA and other private arrangements, indexing is often incomplete. Typically, half of wage gains are arranged through formula, and the rest determined in a bargaining process. The use of bargaining exerts a break on the transmission of inflation from one sector to the other. In the case of entitlement programs, no such break exists.

Entitlement programs have been fully indexed to changes in the cost of living. Omitting indexing if inflation is less than 3 percent emphasizes administrative convenience rather than the critical issue of the stability of the economic system. A preferred approach, negotiated indexing, is to fully index say, the first 5 percent of price changes, but to raise benefits perhaps only by half as much for price changes above 5 percent. Further adjustments can be made by the Congress at its discretion, without being so automatic, rapid, and complete so as to fuel the fires of inflation in times of economic stress. I believe that negotiated indexing, 50 percent for changes above 5 percent and fully up to 5 percent is preferable to delaying cost of living adjustments, adjusting according to the lower of the change in prices or wages, or adjusting benefits for a constant percentage of the rate of inflation at all times.

The negotiated indexing approach can be integrated with a decision on whether to index on the basis of prices or wages. The economic function of wage indexing is to pass productivity gains as well as cost of living increases on to persons whose incomes would otherwise be fixed in real terms. This practice is widespread throughout Europe.

Without benefit increases greater than the rise in the cost of living, persons on fixed incomes would not share in economic progress. Full wage indexing is not appropriate, however, because an important part of the rise in productivity is attributable to the specific actions of individuals such as further education, for which the individuals making an effort should be specifically rewarded. Productivity gains which result from general sources which should be shared with beneficiaries of entitlement programs. In the long run, this means that benefits rates ought to increase at something like half of the excess of wage growth over inflation.

Practical application of these concepts requires dealing with three issues: (1) Benefit level. There is no scientific way of determining the appropriate level of benefits under entitlement programs. Judgments must be made about the public's desire to provide a standard of living for those who are dependent and complicating factors like work incentives must be taken into account. Historical decisions offer a guide, but there can be changes in public attitudes or circumstances. (2) Updating. Benefits must be set using some concept of an appropriate indexing system under normal conditions. (3) Adjustment. The Congress may also wish to allow for overindexing in the past, arising both from problems with price indexes and problems with benefit formulas.

Moreover, as much as it is appropriate to share progress resulting from productivity gains from general sources, it is also necessary to share the losses resulting from productivity declines attributable to general forces like increased energy prices and regulation. The problems of overindexing and productivity declines raise a legitimate issue of whether give-backs are necessary in order to restore a balance to benefit levels from which future increases can proceed in a more orderly way.

On a long run basis, it is appropriate to increase benefits at a rate of half of the excess of wage changes over cost of living increases. In the short run, it is appropriate to increase benefit levels at a rate less rapid than cost of living changes in order to make up for disproportionate increases over the last several years. A system of negotiated indexing would serve this purpose, gradually moving benefit rates back into line with those which would have prevailed had a more appropriate indexing system been in use all along. Thus, I recommend a negotiated indexing system which will rate benefits by 5 percent plus half of the rate of inflation in excess of 5 percent for the next several years. Special increases would be added to periodically raise benefit levels to the point that would prevail if benefits were indexed to half of the excess of wage gains or inflation.

To Illustrate, assume that in each year, the rate of inflation is 8 percent. For the next four years the formula would provide increases at 6.5 percent per year (5 percent plus half of (8–5) percent. Over four years, increase would be 6 percent less than with full indexing. Suppose that in the following years, wage changes are 10 percent per year. The formula would require that at the end of the 8 years there be a special adjustment of 10 percent in benefits, 6 percent for catch-up cost of living adjustments and 4 percent for productivity gains. After 10 years, beneficiaries would return to the benefit levels that they would have received with full indexing and no productivity sharing, and after 10 years, they would be better off a result of participating explicity in the progress of the economy.

This system has the effect of deferring substantial cost of living adjustments over the next several years, and creating a large cumulative reduction in the costs to the treasury. It would restore a balance and allow more automatic and certain adjustments in the future and reduce the risk of magnifying inflationary effects.

PREPARED STATEMENT OF JOSEPH J. MINARIK

My name is Joseph J. Minarik, and I am Deputy Assistant Director of the Tax Analysis Division of the Congressional Budget Office (CBO). I appreciate the opportunity to testify before this subcommittee today on the revision of the Consumer Price Index (CPI) and special group price indexes. Because Alice M. Rivlin, director of the CBO, has already entered her detailed testimony into the record, I will only briefly summarize that testimony in a prepared statement at this time.

THE REVISION OF THE CONSUMER PRICE INDEX

The preponderance of expert opinion has for some time held that the Consumer Price Index as currently formulated is a poor measure of the rate of inflation. The failing of the CPI is its treatment of owner-occupied housing. The present formulation exaggerates the importance of home prices and particularly of mortgage interest rates in the price structure of the economy. To make this statement is not to criticize the Bureau of Labor Statistics (BLS), which instituted the current treatment of owner-occupied housing in 1953 when today's rapid inflation and high interest rates could not have been foreseen.

The Bureau of Labor Statistics' future rental equivalence treatment of owner-occupied housing for the CPI should be welcomed. The rental equivalence approach makes the vital distinction between the shelter and the investment costs of homeownership. Thus, the weight assigned to homeownership and the price computed for it in the CPI will correspond only to what the homeowner pays for the shelter of the home, not for any additional spending intended as an investment toward a future return.

In recent years, the CPI has increased more rapidly because of the flaw in its treatment of homeownership. It would be a mistake, however, to say that the CPI inherently exaggerated inflation, and that the revised CPI will show less inflation than the current version would. In fact, what the current CPI exaggerates is movements in home prices and mortgage interest rates. These movements could be up or down, fast or slow. Therefore, the effect of revising the CPI depends on economic developments that are extremely difficult to forecast.

To play out a few scenarios: If interest rates and house prices remain at their current levels, those components of the current CPI would show no change (that is, zero inflation). The revised CPI, which would omit those components and put more weight on other goods (whose prices would presumably increase at some nonzero rate), would show more inflation, not less.

Suppose alternately that mortgage interest rates fell from current levels. Then the current CPI would place a heavy weight on a negative component, and again would show less inflation than the revised CPI.

Finally, imagine a financial crisis in which interest rates rose sharply from their current levels—the kind of deterioration that has been inconceivable for the past 15 years. Under those conditions, in contrast to the two scenarios above, the revised CPI would show less inflation.

The CBO's current economic forecast implies a general slow decline of interest rates over the foreseeable future, as most other forecasts do. This would suggest that the federal government's indexed outlays could be held down by postponing the changeover to the revised CPI. However, our ability to forecast future interest rates is admittedly weak. Unforeseen developments could easily reverse any projection. It might be wiser to change to the more conceptually sound index, comforting ourselves with the knowledge that, by Murphy's law, whichever index we choose in order to minimize federal outlays will inevitably turn out to be the wrong one.

Behind this facetious argument lies a grain of serious analysis. The worst possible contingency for the indexed federal programs would be a shock to the economy causing higher interest rates and unemployment while the current CPI is in use. In that event, indexed outlays would increase sharply because of the CPI's flawed treatment of homeownership, and federal income and payroll tax revenues would be reduced at the same time. On the other hand, if we implement the revised CPI, we at least minimize the bulge in indexed outlays in this worst case scenario. Of course, implementing the new index will not give us the greatest outlay savings if interest rates should fall sharply, but most of us would gladly accept such bad luck.

SPECIAL GROUP PRICE INDEXES

Another topic of recent interest is the desirability of the creation of special group price indexes. Our knowledge in this area is extremely limited, and so we should move with caution.

Construction of a new price index for some special subgroup of the population—in particular, the elderly—would be extremely costly and time consuming. We should therefore proceed if, and only if, there is solid evidence that the new index would depart significantly from the current CPI, and if we are to put the new index to use in some federal government program. It is not at all clear that either of those two conditions is met.

First, the evidence on the rate of inflation in the market basket of the elderly, relative to that of the general population, is extremely sketchy. The work that has been done in this area suggests that the divergence between the inflation rate faced by the elderly and that of the population at large, if there is any divergence at all, is very small.

Second, there is a real question as to whether such a price index for the elderly should be used. Some analysts believe that a price index for the elderly would show that that subpopulation faces more rapid inflation, and thus would justify greater indexation of Social Security benefits. Unfortunately, while more rapid inflation in an elderly price index might lend intellectual support to greater indexation, it would not pay for it, and the Social Security system is in rough financial waters as it is. Other analysts believe that an elderly index would increase more slowly than the CPI, and thus justify a cutback in indexation. This group might think again about the inevitable controversy involved in indexing Social Security at a rate less than the general rate of inflation, by which many other programs are indexed. And both groups might consider how we would treat the almost one-third of Social Security beneficiaries who are not elderly, and the chaos that would arise if we tried to index different beneficiaries by different indexes.

An alternative proposal would be to create an elderly price index on an experimental basis, using the current CPI with slightly altered weights as a basis, merely to observe its behavior relative to the index for all urban consumers. This proposal seems harmless enough, but it has dangers of its own. Such an experimental index would differ significantly from an actual price index for the elderly, begging many important statistical questions. The current CPI is not designed to represent the geographical location of the elderly, or the stores at which they choose to shop; rather, it reflects those patterns for the entire urban population, which may be different from those of the elderly. (Another question is what goods and services the elderly consume; we have some information on this question from the data on the elderly who were sampled in the construction of the current CPI.) As a result, extreme controversy would be sure to follow the release of an experimental elderly price index based on the CPI. If it differed from the general index, one group of analysts would praise it and demand that it be made official, while others would attack it for its conceptual flaws. On the other hand, if the experimental elderly price index did not differ from the CPI, then both groups would argue that the experimental index was flawed. And in the final analysis, we would have learned nothing.

If we wish to learn more about the effects of inflation on the elderly, we should consider the merits of some basic research: Where do the elderly shop? How do prices change at those outlets, as opposed to the outlets frequented by the population at large? How have public and private insurance affected the medical care costs of the elderly? Answers to these questions will be needed to assess the importance of, and to construct, a price index for the elderly.

PREPARED STATEMENT OF ALAN S. BLINDER

Mr. Chairman, I want to thank you for inviting me to appear before the committee. Because there are so many proposals to reduce indexing afloat today, I would like to begin by addressing the basic reasons for indexing, and arguing that these are very good reasons indeed. Then I would like to suggest that, contrary to many statements I have heard and read in the press, indexing is not to blame for our current and impending budgetary problems. Next, I will discuss some proposals to limit indexing. And finally, I will say a few words about whether the Consumer Price Index is the appropriate index to use.

REASONS FOR INDEXING

There are two basic reasons why private parties, such as workers and management, may want to enter into indexed contractual arrangements, and these reasons apply equally well to contractual arrangements between private citizens and the government (such as taxes and transfer payments).

First, because the rate of inflation is unpredictable, unindexed contracts expose people to risks that can be removed by indexing. For example, suppose a company, believing that inflation will be 8 percent in the coming year, agrees to raise wages by 10 percent. It wants to pay a 2 percent real wage increase. But if inflation is 10 percent, workers will get no real wage increase; while if inflation turns out to be 6 percent, the company will pay a 4 percent increase—twice as much as it planned. If they write an indexed wage contract instead, both labor and management can be sure that the actual increase in real wages will be 2 percent, no more and no less.

Government transfer payments are exactly analogous. An 8 percent increase in social security benefits will keep the purchasing power of benefits the same if inflation is 8 percent, cut real benefits if inflation exceeds 8 percent, and raise real benefits if inflation falls short of 8 percent. If you believe, as I do, that the Congress, not the inflation rate, should decide how generous social security benefits should be, then it makes sense to index these benefits.

The second reason for indexing is to prevent certain serious distortions of economic decision making that inflation might otherwise cause. Put crudely, the objective is to enable the economy to function with inflation just as it would without inflation.

In this case, the taxation of interest income is probably the clearest example. (See Table 1.) Suppose there is no inflation, the interest rate is 4 percent, and the tax rate on people who buy corporate bonds is 40 percent (column 1). Then the holder of a $1,000 corporate bond will receive $40 in interest and pay $16 to the government in taxes. The corporation will be allowed a $40 tax deduction.

Now suppose a 10 percent inflation starts and the interest rate rises to 14 percent—a 4 percent real interest rate plus 10 percent compensation for inflation (column 2). The bond now pays $140/year, but $100 of this is actually compensation for the erosion of principal through inflation. The taxpayer's real income from the bond is still $40. But how much tax will he pay? Since the IRS counts the whole $140 as income, he will pay $56 in tax—which is more than the income he earns. The effective tax rate is 140 percent (=$56/$40) in this example. Things work out just the opposite way for the corporation. Even though $100 of the $140 it pays each year is really repayment of principal, and so should not be deductible, the IRS lets it deduct the full $140 as a business expense.

TABLE 1.—TAXATION OF INTEREST INCOME

	No inflation	10 percent inflation	10 percent inflation with indexing
	(1)	(2)	(3)
Principal	$1,000	$1,000	$1,000
Interest rate (percent)	4	14	14
Interest	$40	$140	$140
Real interest	$40	$40	$40
Compensation for inflation	0	$100	$100
Taxable income	$40	$140	$40
Tax	$16	$56	$16
Effective tax rate (tax/real interest) (percent)	40	140	40

The upshot of this is that, because the tax system is not indexed, a rise in the inflation rate raises the tax on interest earnings and raises the subsidy on borrowing. Many economists, including myself, view this as a serious distortion of economic decision-making. And it is not the only one (depreciation is another well-known example).

What if the tax code were indexed? (See column 3.) Then the taxpayer would pay tax only on the real interest—$40—just as he would have with zero inflation. Similarly, the corporation would only be allowed to deduct real interest payments—the same $40—just as with zero inflation. So you can see how this example illustrates the basic purpose of indexing: to make various aspects of economic activity immune to inflation.

To summarize, there are two important reasons to index both private and governmental contractual arrangements:

To reduce the risks caused by inflation, risks which become more serious the more unpredictable inflation is;

To eliminate inflationary distortions of economic decision making, distortions which become more important the higher inflation is.

I submit that these are very important purposes and that what we need in the government budget is not less indexing, but more.

INDEXING IS NOT THE PROBLEM

But how do I square this with the widespread view that indexing is partly to blame for our current budgetary problems? My answer is simple: the charge is wrong; indexing is innocent.

What indexing does is make automatic the periodic adjustments in benefits and taxes that Congress more than likely would make in any event. Over fairly long periods—perhaps five years or a decade—it really doesn't matter much whether benefits are indexed de jure or not, because they probably will be indexed de facto anyway. But over short periods, indexing can make a great deal of difference.

Let me illustrate with the case of social security. Prior to 1975, social security benefits were not indexed. (Indexing was legislated in 1972, but did not take effect until 1975.) But, of course, we had inflation before that. Did real social security benefits fall steadily as a result? Of course not, because Congress periodically enacted increases in social security benefits to prevent this from happening. In the short run, of course, the real value of social security benefits was eroded by inflation; the recipients had to bear the inflation risk that I mentioned earlier. So indexing did not raise the trend rate of growth of social security benefits (or, rather, would not have if a better index had been used). What it did do was protect recipients from inflation risk.

TABLE 2.—*Personal Taxes as a Percentage of Personal Income* [1]

1981	12.3	1972	11.4
1980	11.9	1967	10.7
1979	11.9	1962	11.0
1978	11.3	1957	10.7
1977	11.1	1952	11.4

[1] Personal tax and nontax payments (NIPA basis) divided by personal income.

The indexing of imcome tax brackets should be thought of in the same way: not as something that will slow the growth of tax receipts (whether you like that or not), but as something that will reduce the inflation risks faced by taxpayers. In this light, I think it is instructive to look at Table 2, which shows federal personal tax payments as a fraction of personal income for the past 5 years and at 5-year intervals going back to 1952. There are two facts to be gleaned from this table. First, look at the period from 1952 until 1977—a 25-year period during which the price level rose about 140 percent. The fraction of income paid in taxes shows no upward trend, even though brackets were not indexed. Why? The answer is the same as it was with social security: because Congress periodically took action to prevent the tax bite from rising too high. With tax bracket indexing, such actions will become automatic. But they happened without indexing anyway.

The second fact pertains to the behavior of the ratio of personal taxes to personal income since 1977. During the 4 years of the Carter administration, which, as we all know, were highly inflationary years, very little personal income tax cutting was done. This was a departure from previous practices, and you can see that it allowed the ratio of taxes to income to creep upward from 11.1 percent in 1977 to 12.3 percent in 1981. This rise may not seem like much, but it is huge by postwar historical standards and helped precipitate a taxpayer revolt. This would not have happened under indexing.

So the tax rate example illustrates the same points as the social security examples: indexing does not have much effect on the long-term trend in taxes, but does substantially reduce the short-run risks from inflation. That is why many economists view tax bracket indexing as a good idea.

I have often heard it said that indexing must lead to monstrous budget deficits. This is just not so. Part of the reason is what I just said: there is no reason for indexing to change the trends in either spending or taxes; it should just remove the inflation risks from each. The rest of the reason is plain arithmetic: if both taxes and spending were indexed, inflation would push them both up in proportion. The deficit would then rise in the same proportion, and hence be unchanged in real terms. For example, suppose we start with a $100 billion deficit as follows:

Taxes, $600; expenditures, $700; deficit, $100; and then prices rise by 10 percent and nothing happens to real economic activity. Then, after one year, the budget will look like this: Taxes, $660; expenditures, $770; deficit, $110.

So the deficit is 10 percent larger than it was. But, of course, prices are also 10 percent higher, so this deficit represents the same purchasing power as before. The whole idea of indexing, in this context, is to make the real deficit immune to inflation.

As final proof that indexing is not at the root of our current and impending budget problems, we need only take note of two facts. First, tax bracket indexing does not start until 1985, and gaping deficits are projected well before them. Second, these deficits are projected despite forecasts of falling inflation and slower growth in entitlement programs.

PROPOSALS FOR LIMITING INDEXING OF BENEFITS

Nonetheless, indexing has become one of the scapegoats, and many people have looked to limits on indexing of federal benefit payments as one way out of the budget problems we now face. Let me mention briefly three proposals to reduce indexing.

1. Caps: Sometimes it is proposed to limit indexing to some maximum amount, say 5 percent. Then, if we again take social security as our example, benefits would be protected from inflation up to 5 percent but totally unprotected thereafter. If inflation remains above 5 percent, as seems quite likely, this would amount to a total removal of indexing. It would be tantamount to a decision to raise nominal benefits by 5 percent per year regardless of inflation, and it would restore all the inflation risks that were previously removed. I have already outlined the reasons why I view this as a bad idea.

2. Minimum of wage increases and price increases: One proposal that has attracted attention lately is to raise social security benefits by the rate of price inflation or the rate of wage inflation, whichever is lower. This proposal would index benefits as at present whenever wages grow faster than prices, which is the normal case. But it would reduce real benefits whenever wages grow slower than prices, as has happened recently.

Notice that this scheme would still leave beneficiaries subject to some of the inflation risks that I mentioned at the outset: whenever price inflation outstripped wage inflation, real benefits would fall. Notice also that the scheme does not let beneficiaries catch up later. Real benefits would be constant whenever real wages rose, but would fall whenever real wages fell. For this reason, Congress would probably have to legislate benefit increases periodically, and we would be back to something like the system we had before indexing was started.

3. Indexing Above Some Minimum Amount: Martin Feldstein has recently proposed that social security benefits be adjusted upward each year by the rate of inflation minus 2 percent. Notice that this proposal is the opposite of a cap: it provides complete elimination of the risk of inflation so long as inflation remains above 2 percent (which seems certain). What it does, quite simply, is reduce real benefits by 2 percent per year. Thus, whatever its merits or demerits, this proposal should not be thought of as a way to modify indexing. It is, instead, a proposal to gradually lower benefits, and should be judged on that basis.

THE CONSUMER PRICE INDEX

My discussion so far implicitly assumed that we always use the correct price index. In the case of social security benefits, for example, the price index would have to reflect accurately the prices paid by the recipient population. Many people feel that the Consumer Price Index (CPI) has not done this in recent years, and instead indexing has overcompensated social security recipients for inflation. They are probably right.

While a number of problems could be pointed out, the most important is probably the housing component of the CPI. Actually, there are two problems here. Older people probably spend different fractions of their budgets on housing than the population as a whole. They also probably live in different types of homes. For these reasons, even if the CPI did the best job it could of measuring the costs of homeownership, it might not be appropriate for social security recipients.

However, it is by now well known that the CPI does not do a very good job at all of measuring homeownership costs. I have attached for the record a paper I wrote late in 1980 which examined the BLS's current treatment of owner-occupied housing and discussed alternatives. I will not go into these issues now, unless there are questions, because the BLS has already announced its intention to revise the CPI's treatment of owner-occupied housing in much the way I recommended (not, however, because of my suggestion!).

Because it puts too much weight on owner-occupied housing, and because the conceptual treatment of housing expenditures is flawed, the CPI serves many purposes poorly. More is at stake here than just the level of federal benefit payments. To cite just two examples, millions of workers receive wages which are indexed to the CPI, and the CPI is the inflation index that the public watches. Bad indexes are potential sources of mischief. In recent years, the flaws in the CPI's treatment of homeownership have caused it to overstate inflation. But the sword can cut the other way, and if mortgage rates stabilize and come down, the current CPI will understate inflation. Indeed, this has already happened to some extent.

Let me explain. The CPI as currently constituted puts a considerable weight on the rate of interest charged on newly issued home mortgages. It is the rate of increase of the interest rate that affects changes in the CPI, that is, affects inflation. So if mortgage rates just remain constant, even at a high level, then this particular component of the CPI will show a zero rate of inflation, and this will pull down the average inflation rate. If mortgage rates fall, the effect will be even more dramatic, since the CPI will then have a significant component with a large negative inflation rate. (For example, in July 1980 the mortgage interest component of the CPI fell at a 48 percent annual rate, and this was enough to make the overall measured inflation rate zero. It was, of course, ludicrous to think that inflation was zero that month.)

I have gone into these details for a reason. One question before this committee is whether the BLS should be urged to speed up the introduction of its new, and conceptually superior, treatment of housing. My normal attitude toward all questions like this is to say yes without hesitation; good data are always better than bad data. But here there is a special issue that needs to be faced. Recipients of social security benefits and other payments indexed to the CPI have been overcompensated for inflation for the past several years. If interest rates now stabilize or decline, they will be undercompensated in the next few years if we do not change the index. Should these beneficiaries be permitted to keep the higher benefits which the CPI capriciously awarded them, or should we let the CPI take away what it previously gave? That is a political decision.

Of course, there is a cleaner solution, and I think I would recommend it. We could fix up the CPI as soon as possible, leading to a new index that would probably show more inflation in the next year or two than the old one. But, if we thought social security benefits were too high, we could couple this reform with Feldstein's suggestion to give indexing minus 2 percent, or some other plan to cut benefits.

One final remark on the CPI. Housing is not the only respect in which the market basket purchased by older people differs from the market basket purchased by the average American. Medical care, or rather the portions of medical care not picked up by Medicare, is another obvious example. So are the many items associated with child rearing. So, even if the CPI was totally free of conceptual flaws and accurately depicted the inflation rate facing the average American, it might not be accurate for older Americans, and hence might not be ideal for indexing social security benefits.

I submit that the rationale for indexing social security benefits is as I stated earlier: to eliminate inflation risks. If this is so, then a special price index probably should be constructd for the social security system.

Please understand that I do not view this as a major issue. It should be thought of as a small positive step that would improve both the equity and efficiency of social security benefits. I advocate it only because it can be done at so little cost. The BLS periodically collects comprehensive survey data which it uses to determine the weights for the many items in the CPI. It need only record separately the expenditure weights for older Americans and apply these special weights to the same price data it now collects.

Once the CPI's treatment of housing is fixed up, I don't really expect that this "old person's price index" will behave terribly differently from the overall CPI, though it might on occasion. My point is only that it can be done at so little cost that it is worth doing.

Senator **Mattingly**. We have the American Association of Retired Persons, Mr. Hacking; and the Retired Officers Association, Colonel Hennrikus.

Mr. Hacking, would you like to go first?

TESTIMONY OF JAMES HACKING, ASSISTANT LEGISLATIVE COUNSEL, NATIONAL RETIRED TEACHERS ASSOCIATION AND THE AMERICAN ASSOCIATION OF RETIRED PERSONS, ACCOMPANIED BY THOMAS C. BORZILLERI, ECONOMIC CONSULTANT TO THE NRTA-AARP; AND COL. GEORGE F. HENNRIKUS, JR., DIRECTOR, LEGISLATIVE AFFAIRS, RETIRED OFFICERS ASSOCIATION, ALEXANDRIA, VA.

Mr. HACKING. I am here representing the National Retired Teachers Association and the American Association of Retired Persons. These two organizations have a combined membership in excess of 13 million persons, age 55 and older.

I am accompanied today by Dr. Thomas C. Borzilleri, who has done a good deal of consulting work for us and has investigated many of the matters you have been exploring here today before the subcommittee.

I would like to submit the Associations' statement for the record and summarize. If time permits, I would hope that you would allow Dr. Borzilleri a couple of minutes to comment on some of the matters previous witnesses raised before the subcommittee.

The 1972 legislation that indexed the social security program was motivated primarily by two factors. First, was the desire to assure that the purchasing power of benefits would remain constant over time in the face of continuing inflation. The second motivating factor was a desire to bring to an end the series of ad hoc legislated increases in benefits that the Congress inaugurated in the late 1960's and continued on into the early 1970's. That series included a 20-percent increase in 1972.

The primary purpose that motivated the series of ad hoc adjustments was a strong desire to affect a substantial reduction in the incidence of poverty among the elderly population. The poverty rate was viewed as something of a national disgrace and was still at 25 percent as late as 1969.

In the last 2 years, debate over the accuracy of the consumer price index has greatly intensified. It is argued, and with a good deal of persuasiveness, that the CPI, because of the way it treats the changes in the price level of houses and mortgage interest rates, has exaggerated the true rate of inflation in the economy as a whole. Proponents of changes in the CPI also argue that because of this possible exaggeration of the rate of inflation in the economy and because the CPI is used to adjust benefits in programs like social security, those benefits have been increased far too much and that has resulted in substantial over-compensation of the elderly, given what it is they spend their money on.

The Associations wanted to test out the validity of this over-compensation allegation. We therefore asked Dr. Borzilleri to construct a separate CPI for the elderly—an index that was a more accurate reflection of what it is elderly headed households spend their money on. We then asked him to compare what these elderly households actually got from the CPI over the period 1976 through 1980—the period of automatic benefit increases—with what they would have gotten under this separate CPI for the elderly.

The findings were that over the period, the CPI provided some minor under-compensation in a couple of years and some minor over-compensation in a couple of other years. But over the entire period, 1976 through 1980, the CPI gave the elderly roughly what they would have gotten under a special CPI for the elderly. Thus there was no substantial over- or under-compensation during this period.

In view of that finding, and in view of the experience we have had with the CPI relative to the CPI-X1, had the CPI-X1 been used to adjust the benefits over this period, there would have been significant under-compensation of the elderly. That would have significantly eroded the purchasing power of benefits over the period and probably would have driven up the elderly's incidence of poverty.

In order to maintain the purchasing power benefits and eliminate or preclude the possibility of significant over- or under-compensation in benefits, the Associations believe that a separate CPI should be created that is an accurate reflection of what it is social security beneficiaries spends their money on and that this index should be used in adjusting benefits in the major entitlement programs.

But whether, as has been discussed here today, you switch to a rental equivalence-based CPI or even to a separate CPI for the elderly, the effect of any such change is not going to be felt to any great extent in a short term. Yet it is on the short term that the current debate in the Congress over cost-of-living adjustments is focused.

The debate arises not so much in the context of what is to be done to improve the accuracy of the CPI, but rather in the context of what is to be done to prevent the huge projected Federal budget deficits from materializing.

Concern, and indeed perhaps panic, over these projected deficits has prompted a whole series of proposals, to cap, limit, reduce or delay cost-of-living adjustments not just in social security, but in all the entitlement programs. The Associations have consistently opposed all of these arbitrary cost-of-living adjustment reduction proposals for a number of reasons.

First, the currently projected Federal budget deficits arise primarily as the result of the combination of the effect of the current recession, the very large planned increases in spending for defense and large tax cuts enacted last year for corporations and individuals. Given the causes of the projected deficits, we feel it is not appropriate to seize upon the entitlement programs as quick and easy targets for affecting very significant savings on the expenditure side of the budget to prevent these budget deficits from materializing.

While we as organizations very much want these projected deficits brought down and the budget ultimately brought into balance, we think, given the causes of the projected deficits, that Congress should look primarily to the revenue side of the budget, for a solution. If a solution cannot be achieved from that direction, then some additional restraint is going to have to be exercized with respect to planned increases and spending for defense.

Our determination in this regard is reinforced by a number of other considerations. For example, it is alleged by those who want to seize upon cost-of-living adjustments as a quick and easy way of dealing with the budget deficit situation that the elderly, like everyone else, ought to share in the pain of putting our economic house back into some semblance of order. They apparently chose to ignore the very substantial pain the elderly have sustained over the past decade.

While it is true Government programs have brought the elderly up from the bottom of the income scale in terms of both money income and benefits, it is also true that the rate of inflation which has risen to ever higher levels over the period of the seventies has drastically eroded the private supplementing income components in the elderly total income makeup. So while the programs have brought the elderly up from the bottom of the income scale, inflation has pushed them down from the top, causing them to sustain very substantial losses due to inflation over the period. As a result, the elderly have tended to be concentrated increasingly in lower reaches of the income distribution and thus in a situation where they are in grave jeopardy of falling into the poverty category if there are significant cut-backs in the entitlement programs.

Senator MATTINGLY. Let's try to keep it with the CPI, Mr. Hacking, which is what we are debating. Let's try to keep it in that vein.

Mr. HACKING. All right.

I will just stop at that and not go on about the deficit or the proposals to deal with it by capping or limiting COLA's. But I would just point out that that is the major focus of the debate in Congress at the moment. We certainly do not want the issue of improving the CPI's accuracy to be confused with limiting COLA's as a way of dealing with the deficit.

Senator MATTINGLY. Thank you.

Mr. HACKING. Could I prevail upon you to allow Dr. Borzilleri to make a couple of comments on the testimony of the preceding panels.

Senator MATTINGLY. So long as the topic sticks to the CPI.

Mr. BORZILLERI. I will be very brief. I would like to raise a couple of issues with respect to the way the CPI is currently constructed. I have not heard these matters raised here this morning.

Pretend that you are retired and you have a wife in a nursing home. You get a notice in the mail that says the payments that you have to make to support her in the nursing home are going to double next year. In the first place, the CPI wouldn't know it because the CPI does not directly monitor the price of nursing home care. In the second place, the CPI would not count it because it is a "gift and contribution" on your part and not a personal consumption expenditure. Second, think for a moment about the area of what is called medigap insurance. It is a major component of the elderly's standard of living. It is a major expenditure category for the aged and very important to them.

Medicare only covers 38 percent of the out-of-pocket expenditures of the elderly, so insurance or cash must pay the remainder. The CPI does not price insurance premiums. If medical care costs drive these out-of-pocket medical insurance premiums through the roof, it is not even captured in the CPI. Second, there is a significant difference between the kinds of medical insurance policies that an elderly person needs and the kind of insurance I might buy. I want certain things covered they probably wouldn't. Finally, if you just consider a category, like medical care. We find that last year hospital costs went up 19 percent.

Even that component depends upon what goods and services are included in the category. Medical schools certainly know there is a difference between geriatric medicine and the kind of medicine practiced for the rest of the population. The CPI has a mix of average services bought, paid for, et cetera, by the average population. If there is a major difference in the kind of medical care services the aged consume relative to the average consumer in the U. S. population, once again, you are going to miss what is going on in that component. This takes me to my basic conclusion, and Mr. Hacking has summarized most of my research findings. I think we do need a separate index.

As Ms. Norwood pointed out this morning, when you design an index, you design it with a purpose in mind. If we are planning to use an index to adjust the Social Security benefits, we ought to look at the expenditure patterns of the Social Security population, we ought to look at the right goods, the right services, and we ought to include things in that index that are not included today.

The basic conclusion found in my work is that it is a matter of fact that over the long haul these price changes seem to balance out, but the fact also is in 1975 and in 1976, the CPI was driven by medical care prices and energy prices and resulted in an undercompensation for the aged.

In later years, it has been the housing components driving the CPI's so the aged have been getting a little too much. But the fact is, Senator, it is a random phenomenon. What prices are going to go up next year? If the wrong prices go up next year, we have the aged getting too much, and, while if other prices go up next year, we have the aged getting too little. I think the answer to this is to do what Canada does and what a lot of other countries do: use price index based on the aged expenditure patterns, which are very different from the average consumer and construct an index with a specific purpose in mind for indexing Social Security benefits for transfer programs.

Senator MATTINGLY. I think a lot of the testimony given today has shown the problems in the CPI. There was a comment that medicare was overstated whereas housing has been overstated. That is the reason why we are trying to push forward with a CPI-R. In deference to you, the problems in the CPI do not "balance out." There is a margin of difference, a basic inequity as the CPI is applied to all index programs. A small difference in figures makes a tremendous amount of difference in dollars. That is where by revising the CPI and doing away with the varied differences that should not be in there, as well as the idea of CPI-R is such a good idea.

Colonel Hennrikus.

Mr. HENNRIKUS. Thank you, sir. Thank you, also, Mr. Chairman, for persevering to this point. It has been a long morning for you, I know.

Senator MATTINGLY. It is afternoon.

Mr. HENNRIKUS. I am going to be candid, Mr. Chairman. I failed freshman economics.

Senator MATTINGLY. Don't feel alone.

Mr. HENNRIKUS. The first economics professor I ever agreed with, much less understood, is Professor Blinder, as a matter of fact. Consequently, during all those years, I have been occupied in the happy profession of keeping the peace and defending this country when called upon. I represent the Retired Officers Association. I also represent, for this purpose, 15 organizations, all military oriented, all members of an outfit called Council of Military Organizations (COMO).

By the way, I would like to append to my statement COMO's position which is similar, for the record, if I might.

Senator MATTINGLY. You certainly may.

Mr. HENNRIKUS. The opportunity to present the views of our organizations concerning the formula for adjusting uniformed services retired pay is appreciated. Many proposals have been made to modify this formula in order to relieve a near term budget deficit problem. The effect in most instances, however, would be long term. If approved, the administration proposal, for example, would have a lifetime impact on 700,000 current retirees and all future retirees.

For those already retired or those committed to a military career the administration's proposals will constitute a breach of faith.

For others in uniform who have not made a career commitment, it will be a clear message that the retirement system can no longer be considered an incentive to continued service.

For anyone considering changes in the uniform services, its important to understand that it is unique among all other retirement systems and for that matter all other entitlements. It is an integral part of the overall career compensation system and cannot be considered in isolation.

A service member has no vested interest until he or she establishes eligibility for retirement at 20 years service. Military members are prohibited from bargaining for wages or conditions of service.

It is a carefully refined management tool which controls the quality and quantity of the active duty force. Only 7.5 percent of those entering service finally earn retirement benefits. Of this group, all but a few are forced out in mid-life with from 35 to 65 percent of gross pay received while on active duty.

By the way, all this retired pay is subject to taxation.

The pay they receive in retirement is retainer pay, keeping the retiree subject to recall to active duty and to the Uniform Code of Military Justice. At the moment, there are about 350,000 retirees subject to some form of mobilization orders.

One further comment concerning the singular nature of military retirement. With respect to the housing factor which appears to be a significant element in any change in CPI designed for retirees, uniformed services retirees again vary from the norm.

Most service people are unable, due to frequent transfer, to purchase a home until late in their career or, more likely, after retirement.

In my own case, I bought my first home in my 31st year of service, a year before I retired.

Despite its unique nature, the retirement system has been a perennial candidate for cost cutters. The resulting turbulence this has created within the Active Forces has had a marked effect on the ability of the services to maintain some degree of stability.

While proposals to change the retirement system have little or no affect on recruiting or even first reenlistments, they become a major factor for those middle grade people making career decisions.

Last year, a Congressional Budget Office official observed in testimony before the House Armed Services Committee that the Government's treatment of the retirement systen is a key indicator for the Active Forces as to their own treatment.

Defense and service statements made to the Congress in the past few months were highlighted with glowing reports of recruiting goals achieved and record high reenlistment rates. The 2 year effort to reverse 8 years of pay caps plus high unemployment combined to make these possible. We are convinced that when the current recession ends, the savings that might be achieved by reducing the value of the military retired pay will most certainly be counterbalanced many times over by the cost of recruiting and training replacements for those who feel that their future security and that of their families has been jeopardized.

Earlier this month, the Joint Chiefs of Staff stated its opposition to the administration proposal in a memorandum to the Secretary of Defense Weinberger. It expressed particular concern over lower retention rates which could result in decreasing experienced levels, increased recruiting and training requirements, and diminished readiness.

We fully agree with the JCS and the individual services in this matter. All we ask, Mr. Chairman, is that uniformed services personnel be dealt with in an even-handed way. The burden for assuring an adequate national defense posture resides in the Congress.

Military people should not be asked to assume more than their fair share of the burden. If it is determined that the military retirement system needs to be modified, then any change should be accomplished on the basis of all the facts available and predicated on national security requirements and should not be driven by short-term budget considerations.

Between 1972 and 1980, the CPI adjustments have exceeded the annual increases in military basic pay, because of pay caps or reallocation of the raises into allowances and bonuses.

Now that active duty pay has been restored to comparability, there are proposals to link retired pay to future active duty basic pay raises or the CPI, whichever is the lesser.

I would remind the committee that this linkage formula was broken in 1963 as a savings measure and many older retirees are still suffering a reduced retired pay as a result of that prior action.

How can we be certain that some future Congress will not decide at some later date to again break this linkage. Whatever the Congress does in this matter it should insure that the retirement income system should not be changed after the service member has completed the service.

The service member should receive the benefits under the system in existence at the time of the service. Before the Congress establishes linkage with active duty basic pay for future retirees, it should also consider restoring that linkage for those retired prior to 1963.

That is all I have, Mr. Chairman. I might add, as you understand, I am just pointing out the variance between this particular entitlement and all other entitlements. A further question might be asked whether we should be within this system of CPI. I am not certain.

Senator MATTINGLY. One question: Do you agree that there ought to be some type of cap on the annuities as far as we have certain people that are in retirement that are drawing more in retirement than the person in the same pay grade in the Government?

Mr. HENNRIKUS. To my knowledge, no military retiree draws more than an active duty member of the same rank and years of service. Also, pay is the result of congressional action predicated on the need to maintain the quantity and quality of the force. Therefore, no individual should be penalyzed by an after-the-fact correction.

Therefore, I don't think anyone should have to pay for what has happened beyond their control. I don't agree with capping.

Senator MATTINGLY. But you don't think there is an inequity out there?

Mr. HENNRIKUS. Sir?

Senator MATTINGLY. You think they should be drawing more retirement?

Mr. HENNRIKUS. I draw more than any full colonel in retirement. I retired in 1974. My annual pay is $43,310. I don't back up to the pay table for it. I earned every bit of it. By the way, an active duty Colonel with 30 years or more of service receives $52,759.

Senator MATTINGLY. But it should be considered with fairness and equity.

[The prepared statement of Mr. Hacking and Colonel Hennrikus, with an attachment, follow:]

STATEMENT

OF THE

NATIONAL RETIRED TEACHERS ASSOCIATION

AND THE

AMERICAN ASSOCIATION OF RETIRED PERSONS

BEFORE THE

SENATE GOVERNMENTAL AFFAIRS COMMITTEE

SUBCOMMITTEE ON CONGRESSIONAL AFFAIRS

ON

THE CONSUMER PRICE INDEX AND

INDEXING OF GOVERNMENT ENTITLEMENT

PROGRAMS

APRIL 20, 1982

Entitlement Indexing: Bulwark Against Poverty

Faced with rising deficits, Congress has been casting about for a relatively simple and quick means of procuring large and immediate budget savings. Since cost-of-living increases in all federal entitlement programs now make up a sizable portion of the budget, they have been a convenient target. What is ignored by those who have espoused drastic reductions in cost-of-living increases is the devastating impact such cuts would have on the elderly -- especially on the most vulnerable subgroups among them -- namely the oldest and the poorest. Older women, many of them widows, unfortunately comprise the bulk of this vulnerable class.

For roughly 4 million older persons, cost-of-living increases provided by social security and other retirement programs are the only income that stands between them and poverty. Indexing mechanisms are the only inflation protection they have. A decade of high inflation has rapidly eroded the value of their non-indexed sources of income, such as private pensions, savings and other dollar-denominated assets. This situation has left the elderly -- through no fault of their own -- heavily dependent on federal entitlement programs.

It is often argued that the Consumer Price Index (CPI) has significantly overcompensated the elderly for inflation. These assertions are wrong. The best studies (discussed later in this statement) show that the elderly concentrate their spending on necessities, the prices of which have risen rapidly. The only way to resolve this issue is to construct and utilize a special CPI that accurately reflects the elderly's expenditure patterns.

A number of Congressional budget alternatives propose to reduce cost-of-living adjustments. Perhaps the two most prominent are those offered by Senators Domenici and Hollings. Their original proposals would entirely eliminate the 1982 cost-of-living adjustment (COLA) in social security as well as the other income security programs such as SSI, civil service, military and railroad retirement and veterans' pension program and, in succeeding years, provide a COLA calculated to be the Consumer Price Index (CPI) minus 3 percent. Another COLA proposal surfacing in budget compromise discussions between the White House and Congress would delay payment of the 1982 COLA by three months and cap it a 4% in 1982 and in succeeding years.

Lost in all the talk of macro-dollars and fiscal years is the likely impact of such a cut on the elderly. To explain the impact of the proposed COLA cuts in individual terms, social security beneficiaries -- by far the largest group to be affected -- can serve as valuable examples.

According to the Social Security Administration (SSA), the average social security benefit for a retired worker is $4,620 per year ($385 per month) -- only $260 above the official 1981 poverty level for singles of $4,360.

For this average social security beneficiary, the original Domenici/Hollings proposals would cut benefits in the first year by $372 (almost one month's benefit) and by $2,544 over the 1982-85 period.

Similarly, according to SSA, the average social security benefit for a retired couple is $570 per month ($6,840 per year).

For a retired couple, the proposals would cut benefits in the first year by $552 and by $3,804 over the 1982-85 period.

Even more startling data is contained in two reports recently prepared for our Associations by an outside economist, Thomas C. Borzilleri in cooperation with Data Resources Inc. (DRI). We would like to submit these reports for the Committee's hearing record.

The first report, entitled "The Distribution of Income and Social Security Benefits Within the Aged Social Security Beneficiary Population in 1980" contains detailed information regarding average social security benefit amounts, poverty rates, and social security dependency rates of the beneficiary population age 62+.

The conclusions of this report are as follows:

* Any "across-the-board" social security cut, like a COLA cut, will disproportionately hurt the oldest and lowest-income segments of the aged population because they depend on social security for the bulk of their total income. Single elderly persons age 62+ with incomes below $4,000 (approximately the 1980 poverty threshold) depend on social security for roughly 80-85% of their total income; elderly persons age 62+ in a family unit with incomes below $5,000 (the 1980 poverty threshold for couples) similarly depend on social security for 75 to 90% of their total income. The more heavily dependent on social security a person is, the more an erosion in social security implies an erosion in total income.

* Poverty among elderly persons living alone (especially women, many of whom are widows) is extremely high and has risen precipitously over the last three years. In 1980, the poverty rate for all persons age 65+ was 15.7%--the highest poverty rate for any adult age group. This "average" poverty rate compares to poverty rates among the single aged social security population of:

28.6% for single women 65 - 71
33.7% for single women 72+
23.3% for single men 65 - 71
25.5% for single men 72+

Counting all social security recipient households age 62+ (including both single and family units), over 3.6 million older persons had incomes below official poverty in 1980.

* So many of the elderly are clustered just above the poverty threshold that relatively small drops in income will cause poverty rates to escalate dramatically. Among single social security recipients age 62+, 18.4% of them or roughly 1.5 million persons had incomes in 1980 between $4,000 and $5,000, within $1,000 of official poverty. Among families headed by a person 62+, 13.7% or about 2.5 million persons had incomes within $1,500 of the official poverty line. Thus, in 1980 roughly 4 million older persons, while not officially defined as "poor" had incomes low enough to put them at risk of becoming officially poor should substantial cuts in social security be legislated.

The second report, entitled "The Impact of Proposals to Modify Social Security Cost-of-Living Provisions on Aged Poverty, 1985 and 1990", analyzes a simulation of the numbers and types of aged persons who will be pushed below the poverty threshold by 1985 and by 1990 if COLAs are reduced in either of two ways: 1) a freeze in 1982 and inflation minus 3% thereafter or 2) a two-thirds cap on the COLA beginning in 1983 and applied in years thereafter. The computer simulations were produced by the DRI-AARP Age-Income Model which translates the values forecasted by the DRI long-term macro-economic model into changes in income and poverty rates among the aged. The dramatic rise in aged poverty forecast by this study is reinforced by the statistical findings of the report (discussed above) which observed a significant clustering of aged individuals just above the poverty line.

Highlights of this report include:

* In 1980, there were 4.1 million persons 62+ below the poverty line. If full social security COLA's continued to be paid, the number of aged in poverty would remain about the same through 1985 and would gradually decline to 3.6 million by 1990.

* The COLA cut options examined in this report would cause substantial increases in the number of elderly in poverty. The 1982 freeze followed by inflation minus 3% would push 1.2 million additional elderly into poverty by 1985 and an additional 2.1 million by 1990. The two-thirds cap option would force one-half million additional elderly below poverty by 1985 and 1.3 million by 1990.

* Poverty rates among older women age 72+ -- already the highest of any aged subgroup -- would rise substantially under both COLA cut options. For example, by 1990 the expected poverty rate for this group is 26.1% (assuming full COLA's); with CPI minus 3%, it is 38.6% (almost 50% higher) and with the two-thirds cap, it is 34.3% (or 31% higher).

The main conclusions which can be drawn from these reports and other related data available from the U.S. Bureau of the Census are:

* The elderly are a low-income group, especially compared to the non-elderly -- in 1980, 56% of households age 65+ had incomes from all sources below $10,000 and 26% had incomes below $5,000 as compared to 20% of the non-elderly who had incomes below $10,000 and 8% below $5,000. Even adding the "value" of in-kind benefits to the elderly's income will not alter this disparity.

* The elderly, especially those in the lower income reaches, are extremely vulnerable to cuts in social security and other federal retirement programs on which they heavily depend; since so many elderly (from 10-15%) hover just above the poverty line, a small drop in income will cause a rapid escalation in poverty.

* Cost-of-living increases have been keeping many elderly out of poverty. Any curtailment of those increases will not have trivial consequences -- it will have an immediate and dramatic effect on a large segment of society which is in no position to afford such cuts.

II. General Comments on BLS-Proposed "Rental Equivalence Index"

The Bureau of Labor Statistics (BLS) recently proposed a major revision in our nation's most-commonly used measure of inflation, the Consumer Price Index (CPI). This revision to a rental equivalence measure, is designed to remove the volatile effects which rising house prices and mortgage interest rates have on the CPI.

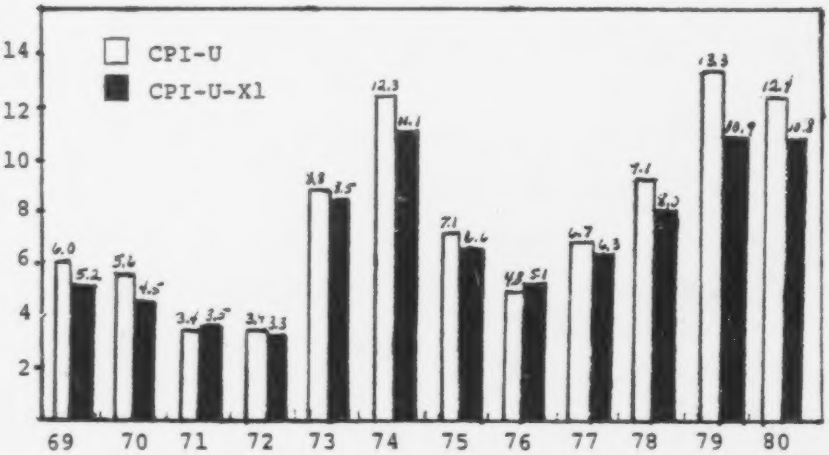
The CPI-W, the measure used to index most federal programs, would be revised to a rental equivalence measure effective in January 1985. This new measure will have a major impact on income tax revenue and on federal benefits paid to millions and millions of older persons through a whole array of income maintenance programs, including social security, railroad retirement, civil service retirement, veterans' pension, food stamps, and Supplemental Security Income. For this reason, our Associations urge Congress to examine closely the proposed index change as well as alternative indexes (such as the one we are recommending) before this change is allowed to become effective.

At the outset, allow me to make clear that our Associations are not opposed to correcting the CPI's flawed treatment of homeownership costs. However, with respect to the federal programs which provide income protection to the elderly, we must insist that all the flaws contained in the current CPI be corrected and that an accurate index reflecting the elderly's expenditure patterns (as best we know them) be constructed and used in providing cost-of-living adjustments in these programs.

In the past, rough economic justice has been provided the elderly by using the general CPI to measure cost-of-living adjustments. There is no guarantee, however, that the current CPI or, for that matter, the newly proposed rental equivalence index, would provide the elderly with rough economic justice because there are fundamental differences between their expenditure patterns and those of the non-elderly -- differences which neither of these indexes reflect. The government cannot continue to ignore such large differences because they could have a major impact on the income security of older Americans as well as involve billions of dollars in federal government expenditures.

As reflected in the Table on the next page the rental equivalence index (CPI-X1) has increased less rapidly over the past decade than the CPI. In the most recent period, 1978-80, the differentials have been sizable: 1.1% in 1987, 2.4% in 1979 and 1.6% in 1980 (The 1981 differential is also expected to be substantial).

Table 4. Comparison of CPI-U and CPI-U-X1
(Percent Change December to December)



Source: Congressional Budget Office, Indexing with the Consumer Price Index: Problems and Alternatives, June 1981, p. 45.

In examining past experience with the CPI-X1, Congress ought to be careful about assuming that past experience can be projected into the future. Our economy is in an extremely volatile state. Future trends in the inflation rate, monetary policy, mortgage interest rates and in the housing or rental markets are simply too difficult to predict and it is these trends which will determine whether the CPI will rise or fall more or less rapidly than the CPI-X1.

If mortgage interest rates fall, the CPI would likely drop more quickly than the CPI-X1. If rises in house prices begin to taper off (which has partially been the effect of high mortgage interest rates) or if rents begin to rise in response to increased demand or shortage of rental property, then the CPI would tend to be depressed relative to the CPI-X1.

While it is possible that the CPI could continue to outpace the CPI-X1 in the near term, this is less likely to be our experience if inflation begins to subside. And, over the longer term, some analysts expect that demand for housing will drop as demographic pressures attendant with the current post-war baby boom population subside.

III. Flaws in the CPI and the Need to Develop a Special CPI for the Elderly

Although many economists and members of Congress have argued that the current CPI tends to overstate inflation for the elderly because of its faulty treatment of housing costs and sensitivity to high interest rates, detailed studies of the issue do not confirm this contention. An exhaustive study conducted for our Associations by an economist, Dr. Thomas Borzilleri, investigated the accuracy of the CPI and found no consistent pattern of over or under compensation for inflation. Copies of his study is available to the Committee.

Based on data collected from the 1972-73 Consumer Expenditure Survey, the Borzilleri study constructed a special CPI or social security market basket to reflect the elderly's special expenditure patterns. The study calculated rates of inflation under this special social security market basket and compared them to rates of inflation yielded by the CPI-W since 1972.

In constructing a special social security market basket, the study utilized the most conservative possible definition of homeownership costs: a house payment that was fixed throughout the entire 8-year period of analysis. In effect, it was assumed that no one in the social security population ever purchased a new home or ever bore higher mortgage interest rates. This definition corrected any alleged overestimate of inflation for the elderly as a result of rises in house prices and the costs of mortgage interest rates.

Given this definition of homeowner shelter costs, the major findings of the study were as follows:

A. Benefits Have Both Underadjusted and Overadjusted, But Differences Have Been Small

Differences between the rate of inflation produced by the general CPI and the rate of inflation produced by the social security market basket, even given the conservative shelter cost assumptions, were found to be quite small. Those differences are reflected in the table on the following page.

In 1976 and 1977, benefits were underadjusted since the CPI increased by less than the social security market basket. In 1979, 1980 and 1981, benefits were overadjusted since the social security market basket increased by less than the CPI.

Over the entire period of automatic indexing, social security benefits increased at an annual average rate of 9.0 percent a year while the social security market basket increased at an average rate of 8.5 percent a year. Relaxing the shelter cost assumption would further reduce this difference. Thus, it appears that no major overcompensation or undercompensation has occurred.

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Table 1. Differences in Rates of Inflation Reflected by CPI-W and Social Security Market Basket Index, 1975-1981

	CPI-W	Social Security Market Basket (SSMB)		Difference between CPI-W and SSMB
		Excluding Cash Contributions	Including Cash Contributions	
75-75	6.4	6.6	6.6	-0.2
76-77	5.9	6.2	6.1	-0.3
77-78	6.5	6.5	6.5	—
78-79	9.9	8.6	8.7	+1.2
79-80	14.3	12.3	12.5	+1.8
80-81	11.2		10.4	+0.8

Note: The category "Cash Contributions" is not used in the official CPI, but such contributions were found to comprise a significant portion of the market basket. Hence, two versions were estimated.

Source: Borzilleri. "The Accuracy of the CPI For Social Security Cost-of-Living Adjustments", May 1981 and "Inflation and the Social Security Cost-of-Living Adjustment, 1981", July 1981.

Putting this into a dollars and cents perspective, in June 1975, the average social security benefit received by a single individual was $189.49 per month and for a couple, $311.81. From June 1975 thru June 1981, this "average" single social security recipient received a total social security income of $16,411. If, over this same period benefits had been adjusted using the social security market basket, total benefits received would have been $16,329. Hence, even given the shelter cost assumption the total six-year sum of windfall benefits for this average single social security recipient is $82.00.

Couples receiving $311.71 at the beginning of the automatic adjustment period received $26,995 over the 1975-1981 period. Had the social security market basket been used instead, payments would have totaled $26,862, a six-year "windfall" sum of $133.00.

Table 2 on the next page illustrates the differing benefit adjustments yielded to various categories of social security recipients by the 1981 social security cost-of-living increase compared to a "proper" cost-of-living increase produced by the social security market basket index.

These "windfalls" are obviously small and the above calculations neglect losses associated with the lag between the time the index change is measured and the time benefits are actually adjusted. The longer this lag, the more purchasing power is lost. In the social security and Supplemental Security Income programs, increases lag three months behind the measuring period and anywhere from 3 to 18 months behind the time when rising prices diminish benefit purchasing power. A January 1981 Office of Management and Budget study (entitled Report on Indexing Federal Programs) indicates that since 1975 (when automatic indexing of social security and SSI payments began), beneficiaries of these programs have experienced a 3.4% decline in real benefit levels due solely to the lengthy lag time in

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Table 2. Average Annual Benefit Levels and Benefit Adjustments, 1980-1981, Various Categories of Social Security Recipients

	Pre-COLA July 1981	After COLA Adjustment	"Proper" COLA Adjustment[1]	Monthly "Windfall"
Retired Worker	337.00	374.74	372.05	2.69
Aged Couple both receiving benefits	576.00	640.51	635.90	4.61
Survivor, mother and two children	782.00	869.58	863.33	6.25
Aged Widow	313.00	348.06	345.55	2.51
Disabled Worker, wife and children	731.00	812.87	807.02	5.85
All disabled workers	372.00	413.66	410.69	2.97

---

[1] "Proper COLA Adjustments," is what benefits would be if the adjustment had been made with the social security market basket index as calculated in the Borzilleri study, "Inflation and the Social Security Cost-of-Living Adjustments, 1981".

Source: Social Security Press Office
News Release, April 23, 1981

adjusting benefits and the rapidly accelerating inflation rate. This decline more than wipes out the small windfall resulting from use of an inaccurate index.

B. Expenditure Patterns for the Retired Are Different From Those Reflected by the CPI.

Major differences in expenditure patterns are obvious when the general CPI is compared to the social security market basket. It should be apparent from the table below that food, fuel and utilities, and medical care play a much more important role in the market basket of the retired. This greater importance, coupled with the higher inflation rates in these three categories in the 1970's, offset or almost offset the major differences in shelter costs between these two inflation measures.

Table 3. Percentage of Market Basket, By Category, CPI vs. Social Security Market Basket

	CPI	Social Security Market Basket
Food and Beverages	20.4	25.5
Shelter	28.0	17.9
Fuel and Utilities	6.4	12.2
Furnishings and Operations	7.3	6.2
Clothing	5.1	4.8
Transportation	20.9	17.7
Medical Care	4.4	9.9
All Other Goods and Services	7.5	5.8
	100.0	100.0

Borzilleri. "The Accuracy of the CPI for Social Security Cost-of-Living Adjustments", May 1981.

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C. Major Over or Underadjustments Could Occur in the Future

These major differences in expenditure patterns have obvious implications for future benefit increases and for the method of indexing utilized by the social security program. To the extent that increases in the CPI are driven by increases in the price of homes or mortage interest rates , social security recipients will be overcompensated. To the extent that increases are driven by rises in the cost of food, fuel or medical care prices, the aged will be undercompensated. Given the importance of cost-of-living protection for retirees, the high cost involved in providing such protection and the major differences in the elderly's expenditure patterns, the necessity for developing and utilizing a separate and accurate CPI to adjust social security benefits is obvious. Until this is done, there will be no assurance that major over or undercompensations will not occur in the future.

Certainly, a separate index based on the market basket of goods and services consumed by the social security recipient population appears a far more appropriate public policy option than proposals to use a rental equivalence index or to cap increases at something lower than CPI. If, for example, past benefit increases had been capped at 85 percent of the CPI increase, social security benefits would have increased by an average annual rate of 7.3 percent while the social security market basket was increasing at an annual rate of 8.0 percent. Thus, if such a cap had been in effect throughout the 1975-1980 period social security benefits would have been significantly underadjusted throughout this period.

If the objective of public policy is to improve the accuracy of social security cost-of-living adjustments, this objective is unlikely to be realized by continuing to rely on the general CPI, by switching to another index like the CPI-X1 or the Personal Consumption Expenditure Price Index, by switching to and from the CPI and wage index, or by arbitrarily capping benefit increases. There simply is no substitute for a cost-of-living index specific to the population in question and designed expressly for the purpose of social security benefit adjustments.

The
Retired
Officers
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Statement of

THE RETIRED OFFICERS ASSOCIATION

before the

SENATE COMMITTEE ON GOVERNMENTAL AFFAIRS

SUBCOMMITTEE ON

CONGRESSIONAL OPERATIONS AND OVERSIGHT

Presented by

COLONEL GEORGE F. HENNRIKUS, JR., USAF, RETIRED

Director, Legislative Affairs

April 20, 1982

Dear Mr. Chairman:

I am Colonel George F. Hennrikus, Jr., United States Air Force Retired, Director, Legislative Affairs of The Retired Officers Association (TROA), which has its National Headquarters at 201 North Washington Street, Alexandria, Virginia. Our Association has a membership of over 310,000 retired, former and active duty officers of the seven Uniformed Services. Included in our membership are 32,000 widows of former members. On this occasion I am also pleased to represent the Retired Enlisted Association of Colorado Springs, Colorado.

This opportunity to present the views of our organizations concerning the formula for adjusting uniformed services retired pay is appreciated. Many proposals have been made to modify this formula in order to relieve a near-term budget deficit problem. The effect in most instances, however, would be long term. If approved, the administration proposal would have a lifetime impact on 700,000 current retirees and all future retirees. For those already retired or those committed to a military career the administration's proposals will constitute a breach of faith. For others in uniform who have not made a career commitment, it will be a clear message that the retirement system can no longer be considered an incentive to continued service.

For anyone considering changes in the uniformed services system, it's important to understand that it is unique among all other retirement systems and, for that matter, among all entitlement programs. It is an integral part of the overall career compensation system and cannot be considered in isolation. A service member has no vested interest until he/she establishes eligibility for retirement at 20 years of service. Military members are prohibited from bargaining for wages or conditions of service.

It is a carefully refined management tool which controls the quality and quantity of the active duty force. Only 7.5% of those entering service finally earn retirement benefits. Of this group, all but a few are forced out in mid-life with from 35% to 65% of gross pay received while on active duty. The pay they receive in retirement is retainer pay, keeping the retiree subject to recall to active duty and to the Uniform Code of Military Justice. At the moment there are about 350,000 retirees subject to some form of mobilizations orders.

One further comment concerning the singular nature of military retirement: With respect to the housing factor, which appears to be a significant element in any change in CPI designed for retirees, uniformed services retirees again vary from the norm. Most service people are unable, due to frequent transfers, to purchase a home until late in their career or, more likely, after retirement.

Despite its unique nature, the retirement system has been a perennial candidate for cost cutters. The resulting turbulence this has created within the active force has had a marked effect on the on the ability of the services to maintain some degree of stability. While proposals to change the retirement system have little or no affect on recruiting or even first reenlistments, they become a major factor for those middle grade people making career decisions. Last year, a Congressional Budget Office official observed in testimony before the House Armed Services Committee that the government's treatment of the retirement system is the key indicator for the active force as to their own treatment.

Defense and Service statements made to the Congress in the past few months were highlighted with glowing reports of recruiting goals achieved and record-high reenlistment rates. The two year effort to reverse eight years of pay caps, plus high unemployment combined to make these possible. We are convinced that when the current recession ends, the savings that might be achieved by reducing the value of the military retired pay will most certainly be counterbalanced many times over by the cost of recruiting and training replacements for those who feel that their future security and that of their families has been jeopardized. Earlier this month, the

Joint Chiefs of Staff stated its opposition to the Administration proposal in a memo to the Secretary of Defense Weinberger. It expressed particular concern over lower retention rates which would result in decreasing experience levels, increased recruiting and training requirements and diminished readiness.

We fully agree with the JCS and the individual services in this matter. All we ask, Mr. Chairman, is that uniformed services personnel be dealt with in an even-handed way. The burden for assuring an adequate national defense posture resides in the Congress. Military people should not be asked to assume more than their share of the burden. If it's determined that the military retirement system needs to be modified, then any change should be accomplished on the basis of all the facts available and predicated on national security requirements, and should not be driven by short term budget considerations.

Between 1972 and 1980 the CPI adjustments have exceeded the annual increases in military basic pay--because of pay caps or reallocation of the raises into allowances or bonuses. Now that active duty pay has been restored to comparability there are proposals to link retired pay to future active duty basic pay raises or the CPI, whichever is the lesser. I would remind the committee that this linkage formula was broken in 1963 as a savings measure, and many older military retires are still suffering a reduced retired pay as a result of that prior action. How can we be certain that some future Congress will not decide at some later date to again break the linkage. Whatever the Congress does in this matter it should insure that the retirement income system should not be changed after the service member has completed the service. The service member should receive the benefits under the system in existence at the time of service. Before the Congress establishes linkage with active duty basic pay for future retirees, it should consider restoring that linkage for those who retired prior to 1963.

Thank you, Mr. Chairman.

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(COMO)

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The Council of Military Organizations (COMO), consisting of fifteen military oriented organizations representing over one and a half million active and retired members of the uniformed services and their families, is deeply concerned about the Administration's proposed reductions in the military compensation system. In effect, these proposals will place an inordinate share of the economic recovery program on the shoulders of people who have given dedicated service to their country. Furthermore, this will be perceived as a blatant breach of trust in which the government, after accepting service, elects to change the terms of that service.

The military retired pay system is the single most significant factor that causes a member to select a military career. Reducing the value of the retirement system will most certainly lessen the services' ability to retain a career oriented professional force. The current success in the recruitment area can be attributed to two primary factors: 1) the recent increases in pay and allowances, and 2) the high unemployment rate that exists in the civilian sector. This success will show dividends only if these newly acquired members are encouraged to reenlist and extend beyond their current commitments. To limit the inducements to reenlist now by drastically diminishing the value of the retirement system would be most foolhardy and ill advised. By enacting the proposed legislation, the national security of our nation could be placed in serious jeopardy through the failure to retain a career force with the ability to maintain and use the technically complicated weapons of modern warfare, and to train others in their use.

Since 1972, basic pay has been subjected to frequent pay caps and reallocations of annual pay adjustments resulting in a depressed initial retired pay. Retirees have been victimized by repeated reductions in the value of their retirement compensation since 1958; the most recent the annualizing of the cost of living adjustment last year. All active duty and retired members will view these current proposals as a breach-of-faith by their government in changing the compensation they expected to receive for the military service they have performed.

Many dependents receiving benefits from the military survivors benefit plans (RSFPP/SBP) will also be adversely affected by these proposals. Retirees who elected to contribute a share of their retirement income for coverage under these programs expected their survivors to receive a level of benefits which were inflation protected. Enactment of the proposed legislation would cause a constant erosion in the standard of living of these beneficiaries. In fact, some of the savings contemplated in this legislation may not be realized since the reduction in SBP benefits, in certain instances, would be replaced by increased Social Security benefits.

Before any action is taken on these proposals it is strongly recommended by the Council of Military Organizations that a thorough detailed analysis be made to insure that the best interests of our nation are served. To approve these proposals arbitrarily in order to achieve short term savings would indeed be a disservice to the men and women who dedicated the best years of their lives to the defense of this nation.

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Senator MATTINGLY. In conclusion, I would just like to say I appreciate you all coming. We will resume the hearings on May 13. A flawed CPI has forced the Government to overspend on all its indexed programs. No program would be "hurt" by using a correct CPI.

The question before us on this testimony today is, How soon will there be economic justice, not only for indexed programs but also the taxpayers. With the inflation dropping so rapidly and with a 14 to 16 month lag time in computing the Consumer Price Index, the over compensation bulge could be staggering this year as the Congress continues to use a flawed CPI.

So in conclusion of this hearing, I would just say everybody agrees the CPI is flawed. It is now up to the Bureau of Labor Statistics and the Congress to try to correct those flaws.

I thank you all very much for coming.

[Whereupon at 12:45 a.m., the subcommittee recessed, to reconvene at the call of the Chair.]

CONSUMER PRICE INDEX

THURSDAY, MAY 13, 1982

U.S. SENATE,
SUBCOMMITTEE ON CONGRESSIONAL
OPERATIONS AND OVERSIGHT,
COMMITTEE ON GOVERNMENTAL AFFAIRS,
Washington, D.C.

The subcommittee met at 9:10 a.m., in room 3302, Dirksen Senate Office Building, Hon. Mack Mattingly (chairman of the subcommittee) presiding.

Present: Senator Mattingly.

OPENING STATEMENT OF SENATOR MATTINGLY

Senator MATTINGLY. This morning's hearing will come to order. Today we are going to begin our second day of hearings on the Consumer Price Index. At our last hearings on this topic before the subcommittee we had a range of economic and policy experts as well as spokesmen for labor and retiree organizations which agreed on the inaccuracy of the CPI. Alice Rivlin referred to the current CPI as a flawed measure. It obviously is not sensitive enough to changes in the cost of living, especially when inflation is acute.

Our last day of hearings determined that CPI must be corrected or Congress must stop using this price measure to make its automatic adjustments to the many indexed programs. It is simply wrong. It has in the past overstated inflation. But this is also a sword that can cut both ways. Unless corrected, the inaccuracies of the CPI can lead to undercompensation for these programs.

I intend to submit legislation which is going to correct the major flaw in the CPI immediately. The CPI is not the proper index to use for many of these entitlement programs. I personally am in favor of some sort of "Retirees Index" which would track the changes in prices faced by our elderly. But until we move to some sort of improved index, there is one step that Congress can take now which would dramatically improve the accuracy of the CPI.

Currently there are two "official" CPI's. The one that is used by the Federal Government to index most Federal programs is only applicable to about 40 percent of the population. This is called the CPI-W. If Congress chose to use the CPI-U instead beginning in 1983 as the index that programs are tied to, we would be using an index that is applicable to 80 percent of the population. Even the CPI-U would be an inaccurate measure of inflation for these programs. But it would be far greater and better than the current index.

A major problem with the CPI that was only discussed briefly at our last hearings, which I hope everyone here will address today, is the problem with the "lag" or excessive length of time in the computation of the CPI and the date that these benefits are distributed.

You can see by the chart on your left, right here, where it says lag time in CPI. We are talking about a 15-month period of time to calculate this flawed index before the benefit is actually adjusted or delivered to the programs.

Dr. Rivlin told us last month that no matter what our rate of inflation is this month, whether it is 1 percent, 2 percent, or even zero, Congress will be distributing this July 1 a 7.4-percent increase in the index on programs and to individuals.

I have a chart, as I said, that states and demonstrates the lag time. It shows how a stale CPI is used to determine the benefit distribution. None of the changes that I am talking about or interested in would affect the CPI change this July. The Federal Government simply moves too slow for any adjustment now. It is almost like carting around a bag of rocks on your back. People are already expecting this increase, and they don't realize it, but they should be informed that it is an incorrect and flawed index. But I am also interested in seeing that these changes are made now so that all of these 44 programs—as you can see over here there are 44 indexed programs—that are tied to this CPI are protected from accusations that they are being overcompensated.

To demonstrate the huge impact this flawed indicator is having upon our economy, I want you all to notice how many programs, as I said, are tied to the CPI. The CBO lists roughly 44 programs that are indexed, but actually there are more than this. There are over 40 more programs or provisions, additional ones, that rise in an indexed manner. The Federal Government has tied so many programs to this index, Congress must insure that this is an accurate index or must stop using it.

You can see the overcompensation, if you will look at this chart down here; $8 billion has been misspent just due to the inaccurate housing component of the CPI in the last 4 years. There are estimates that the overcompensation has run as high as $21 billion in Federal dollars. These are dollars that have been lost because of goofs or changes in this indicator.

The Bureau of Labor Statistics has been doing a good job, but they are not producing a cost-of-living index—certainly not one for the many diverse Federal programs that this has been used to control. I hope today that we can work on these solutions to this problem. As we go along, I think we will see that the legislation I have introduced in the past and that we will introduce after these hearings conclude today will help resolve part of that problem.

Before proceeding I have a statement by Senator Pryor for the record.

[The statement referred to follows:]

OPENING STATEMENT OF SENATOR DAVID PRYOR

Mr. Chairman, today the Subcommittee on Congressional Operations and Oversight holds its second in a series of hearings on the Consumer Price Index. I am pleased that the Subcommittee has chosen to explore this vital and timely issue.

The CPI is one of the most widely used statistics collected by the federal government. Simply stated, this statistic measures the change in prices of a fixed basket of goods, the purpose of which is to adjust benefits in order to help keep purchasing power constant.

In recent years growing emphasis has been placed on the accuracy of the CPI in measuring inflation. This concern has arisen chiefly from two main factors: first, the growth in number and size of federal benefit programs which are automatically indexed to the CPI. In addition, the rapidly rising pace of inflation in recent years has expanded growth in benefit increases in these programs far beyond what was expected. Spiraling budget deficits demand that we leave no stone unturned in our efforts to gain control of the national budget.

Recent studies have indicated that our current method for determining the CPI may indeed be outdated. The Commissioner of the Bureau of Labor Statistics, from whom we heard at our last meeting, has announced the Bureau's intention of phasing in a new CPI by the year 1986. It is, however, extremely important that Congress remain mindful of the effects such changes would have on the millions of Americans who benefit from these programs and make sure that any changes are wise public policy.

I believe that the information gathered at these hearings will be very valuable as both this body and the Senate Finance Committee examine the effects of changes in our entitlement programs will have throughout our nation.

Our first witness today is Dr. Norman B. Ture. I would like to thank Dr. Ture for coming before us. I highly value your input from the Department of the Treasury. Dr. Ture is Under Secretary for Tax and Economic Affairs for our Government. Mr. Ture.

TESTIMONY OF NORMAN B. TURE, UNDER SECRETARY FOR TAX AND ECONOMIC AFFAIRS, DEPARTMENT OF THE TREASURY

Mr. TURE. Thank you, Mr. Chairman. It is a pleasure to be here with you today.

I do not have a prepared statement, but I have some beginning remarks I would like to offer. One, I would have to assure you that my credentials do not include a high level of expertise on the arcane matters of the Consumer Price Index. As a matter of fact, sitting here this morning and listening to your remarks, I think I have learned a lot more than I had known a long, long time back about the indexing of Federal Government programs.

With that disclaimer, let me offer a few prefatory observations.

If you look at just the OASDI program, not your 44 and more programs that are indexed, if you look at merely the OASDI program, one of the things that will strike you immediately, at least it did me, is that, one, there is no question about the fact that cost-of-living adjustments account for a very substantial part of the increase in the projected outlays under those programs over the next 4 or 5 calendar years. And let me indicate just how large that is.

Using the alternative 2(a) projections, which are those that are embodied in the budget and are the sort of central projections of the Board of Trustees, what you would find is that without cost-of-living adjustments, OASDI payments in 1987 would be $52.1 billion less—that is 22.8 percent—than they are projected to be using the CPI rates that are in projection 2(a).

Senator MATTINGLY. Would you repeat that now?

Mr. TURE. Yes. If we didn't have any COLA's at all and you simply started in 1983, calendar 1983, with a dollar amount of OASDI benefit payments—these are again in the calendar years—the aggregate amount of those over the next 5 years, 1983 through 1987, would be something like $52 billion less than the aggregate for those same years is projected to be using the inflation rates as measured by the CPI that are in the alternative 2 projections. That is 22.8 percent, in other words, that COLA accounts for of the total outlays over that 5-year period.

But of the aggregate outlays over that period, which we are projecting at $994 billion, the COLA's account for $156 billion or only 15.7 percent. Now, 15.7 percent, or $156 billion, is not an inconsequential number of Federal budget dollars. But the purpose of citing that to you is the basic problem you have as to the growth in OASDI programs as well as with all of those other programs is not to be found in COLA's per se. They aggravate the problem. They do not originate it.

So I think it is important to bear in mind that whereas COLA's are now occupying a substantial amount of our attention, and for very good reason, there are serious problems associated with the way in which we try to make these adjustments.

We should not identify the cost-of-living adjustment procedure as the source of the difficulties in the Federal budget's tendency to run away from us. It is the basic nature of the programs that we have to sooner or later turn our attention to. In no case could you find a better illustration of that proposition, it seems to me, than in the case of OASDI.

When the old-age and survivors insurance program was first introduced in the late thirties, or became operational in the late thirties, the conception on the part of all the authors and participants in the design of that system, the old-age and survivors insurance assistance, the Government program, was it would be a supplement. It would help the beneficiaries to eke out their retirement income. The principal source of the retirement income was to be found in the private sector, as it always had been.

If you look at the situation today, informally and formally, it is precisely the reverse. OASDI is the primary program and the private sector retirement is the supplement.

If we are looking for longrun solutions to the problems in the social security system, they are not to be found in the cost-of-living adjustment. It has to be found in finding some way in the not very distant future of transiting from a primarily public intergeneration transfer system to a primarily private capital accumulation annuity system.

I am here to tell you, if you do not know it, that is not a small order, but it is an order that I am distressed to observe we have shirked—not just this administration; all of us—and we have done so for years past. I think the time is fast running out on us.

I have always admired the efforts on the part of one commission or the trustees or a study group of one sort or another to come up with cures for the social security system. But most of those cures have looked like quick injections or a Band-Aid or a splint rather than trying to find out what is really the matter with the system and what can be done to provide a much more solid kind of retirement position for the American public over the years. I think we have to get to it.

Let me switch from that to a somewhat narrower issue associated with the CPI and cost-of-living adjustment. One of the things that your fascinating table entitled "Indexed Programs" reveals is that we index irrespective of what kind of program. We index an awful lot of things that probably should not be indexed.

One of the questions we ought to entertain, that you certainly should have high on your list, Mr. Chairman, if I may be so bold to suggest, is what is an appropriate Federal program to index and which are not appropriate? I can't give you any hard-and-fast rules for it. One suggestion that occurs to me right off the top is you would want to index, if anything, wage programs. In other words, you would want to make sure that when the Federal Government goes into the labor market to compete for labor services, it does so on an even-up basis with the private sector—not from a position of advantage, to be sure, but at least certainly not from a position of disadvantage.

Well, there are very few, or to be sure, some businesses, some lines of activity, which seek to index payments and outlays, not anywhere near enough from the point of view of the business community, as I am sure you are aware, but it is not the general rule; it is the exception.

If one looks at your list, one is overwhelmed by the number of things that one would never have expected—I must say, as I sit here, I also have to point out these old eyes cannot read as carefully as they might like to some of the items you have there. But some of them certainly are very impressive. Indexing the guaranteed student loan program, I simply pick that one off the list. The dairy program; the wool and mohair program. One could go on and on.

Senator MATTINGLY. I just want to point out number nine to you, the Federal Reserve Board retirees are also indexed. [Laughter.]

Mr. TURE. That I think you can make a better case for. I think that is part of an element in compensation.

I would suggest that a good case can be made and has been made for providing cost-of-living adjustments as part of the compensation package. It is very extensively done. I don't see any real basis for objecting to it. It is a risky kind of thing. Workers who engage in negotiation for cost-of-living adjustments should be aware of the fact that they are putting themselves at risk. They are trading off other elements in their compensation package for that piece of compensation. They should not be allowed to believe for a moment it is a free lunch. It isn't. They are trading. As long as they are aware of that and want to negotiate for it, I can't see any reservation about it at all.

The same thing is true of the retirement program. If you had a really efficient retirement system, that would mean any employee or any individual thinking about provision for his own retirement would say well, I am very leary about inflation and I am willing to pay a substantial premium today to buy an annuity "x" number of years from now that will protect me more or less from the inroads of inflation.

Now, he would have to know he is going to pay more for that annuity than a level annuity. But he certainly ought to be entitled to make that choice.

I think very much the same thing can be said for the social security system. You ought not to preclude a cost-of-living adjustment.

Let me now turn to the point you have raised, quite appropriately, of what kind of cost-of-living adjustment we should make for social security or any of those other appropriately indicated programs in your list.

One starts with the observation that the Consumer Price Index—either variant, now in existence or any that will come along in the future as currently planned—no Consumer Price Index is a cost-of-living index; nor is it intended to be. It is intended to be an index of the change in the level of prices that go into a consumption basket.

The distinction is not a fine one; it is a basic one. Cost of living is not the same thing as the price level. Cost of living must take account of the fact that among a population of our character—that is, heterogeneous, in terms of where it comes from, its age distribution, what it does to earn its living, how it disposes of its income, what part of the country it is in, and so forth, and so on—cost of living is not a thing that can be measured by any one index.

The point I think you are suggesting, quite appropriately, is that an index for purposes of adjusting retirement benefits for changes in the cost of living of the retirees clearly has to be adapted to their living patterns.

There is an element, an item, in the CPI, for example, which is a most glaring case in point. Fortunately, it has a minuscule weight in the index. But it is very hard to deal with the question of why the index should be adjusted at all, for social security retirement purposes, for changes in the cost of toddlers and infant wear. It is also questionable whether or not the weight that is now assigned in the CPI to such items as educational expenses should carry the same weight in an index that is appropriate for cost-of-living adjustments of retirement benefits. The list could go on and on. I don't have the detailed CPI index in front of me. But you would find, upon even a most casual inspection of that list, there are any number of items that would appear to be improperly weighted—some too low and some too high—for purposes of the retired population.

The one thing that should certainly be done, if the cost-of-living adjustment is to be refined for purposes of adjusting social security payments, annuity payments, one thing that certainly should be done is we have to find a new index or an index derived from the CPI which is more appropriate to that age group in the population. That is not an easy chore. I would not want to convey the impression that one could simply pick up the CPI, quickly go through it, and make a few pencil adjustments and you would have it. You would not. But if in fact this is deemed to be an appropriate undertaking, we should by the same token be prepared to commit some resources in the Bureau of Labor Statistics to this project.

You should be aware of the fact there have been some scholarly efforts to see what difference it makes. I am not adequately familiar with those studies to be able to give you a really expert rundown on them. But most of them suggest that in fact it will make relatively little difference in the aggregate level of the index or its change in any one given period of time. It may very well be that the very constrained change in the index comes from the fact that there is a selection of items rather than selection of weights on the items. That is something which the technicians should be asked to look into.

I think at this point I ought to make myself available for your questions and comments, sir.

Senator MATTINGLY. Thank you.

Do you think that the Bureau of Labor Statistics can create a retirees index with its current resources?

Mr. TURE. I think they probably would need to undertake a special study. They would have to either divert some of their available resources, which are not abundant, or take on special groups for it.

I think if you want that project undertaken, you should be prepared to provide some special funding for it.

Senator MATTINGLY. In that interim period, prior to getting a CPI-R, as I refer to it, for retirees, then you agree that CPI-W is not as representative as the CPI-U would be representative as a measure of cost-of-living increases; therefore, since CPI-U represents 80 percent of the population, that would be a better source to go to than the CPI-W?

Mr. TURE. Mr. Chairman, I would have to point out to you that the fact that one index embraces a larger fraction of the population than another does not mean it is superior for the particular purpose you are addressing. The broader population may very well include more and more people who are atypical dissimilar to rather than similar to the special group in the population you are focusing on, the retired.

But the question you would have to address, and I am not in a position to be able to do that for you sitting here now, is whether or not the "R" index is better represented in terms of its technical components, the items in it, and its weight by the "U" or the "W" index. I don't have the answer for that.

Senator MATTINGLY. The CPI-U does, however, contain the retirees in its calculations whereas the CPI-W that we currently use does not. Retirees have testified in the past it would be a closer representation.

Mr. TURE. That would certainly appear to be for it.

Senator MATTINGLY. Especially since the retired people are the ones impacted probably in a great portion of these indexed payments.

You agreed already, you said, with the earlier witnesses that the CPI is an imperfect method which we are using and probably we should revise it.

Mr. TURE. Whatever can be said on behalf of the CPI or in criticism of it as a price level measure, none of that comment would be appropriate, necessarily, with respect to its utility as a cost-of-living index, and particularly for people who are a special group in the population, the retired.

Senator MATTINGLY. Right. The other thing I have been really concerned about, and I would like to pull this first chart down—before we bring down the first chart, if you want to refer to overcompensation or payout of additional moneys over the last 4 years, since we have been in indexing, due to overcompensation by a flawed index, which has been testified to, this chart shows what it has amounted to, which is an astronomical sum of money. Now, nobody is trying to get those dollars back. I just want to show that we have overcompensated.

But if you pull the next chart out, another major concern that has come up has been in the lag time in CPI, which I have been really deeply concerned about. This is a problem in the timing of the distribution of benefits from when the CPI was first generated. As you well know, in July many of these programs over here and the additional forty-some odd programs that are also indexed at CPI, will be getting a 7.4-percent increase. Everyone knows that the inflation rate is much lower than that now and will be lower at that time. What problems do you see with injecting that much money into the economy at a time when the Federal Government is trying to control inflation? And I will add to that, over here, the way you base the CPI, you study only two different quarters.

What I am getting at is irrespective of whether the inflation rate is going down or whether it is going up, statistically it would seem that we are doing this erroneously, that there should be greater weights given in the last quarter, or some later date because if you are a recipient, whether a social security recipient or military construction recipient, if inflation is in fact going up, you are going to be undercompensated because you are going to have benefits based on old—and lower—statistics.

What is your thinking along that line?

Mr. TURE. You are raising a highly technical question that applies not merely in the measurement of the movement of the inflation process on retirement. Before I got underway, I had shown you a chart that measured the change in monetary aggregates. You have the same problem there. Essentially that kind of a procedure says take a base point and a terminal point, draw a straight line between the two of them, measure the slope of that line, and that tells you the rate of change. Of course it doesn't. It may, but it will be sheer coincidence if it does. In fact, what it tells you is here is the rate of growth between two of many observations.

What you are suggesting, and I think it is appropriate over a broad spectrum of Federal statistics, not merely in the CPI, what you are suggesting is the desirability of a measure of the rate of change which conforms more closely with all of the observations rather than with a small number of them.

I would subscribe fully to that view, again on a technical level, that that would improve the technical efficiency of the measure. But I don't know that that addresses, really, the question of whether or not the adjustment, based on that index in the entitlement payment, will be any better or worse for it. That may be quite a different question.

If we are concerned with the question of how rapidly is the price level rising, then I think the question that you have raised and the suggestion that is implicit in that question is very well taken indeed. If you are concerned with the equity issue of how much should we adjust an entitlement beneficiary's payment in order to make him whole with the current living cost, then I think what we have to recognize is that all of these indexes, no matter how we measure them, by virtue of the fact that they are lagged, will leave him only imperfectly adjusted.

That is a problem which in private contract negotiation would be of minimal weight. That is to say, the two parties to the contract could negotiate what they would regard as the best guess about what is going to happen to the price level, or whatever else was at issue, and contract accordingly. If it turned out that that was wrong, they could have a compensating adjustment built into it.

Senator MATTINGLY. Just to clarify our attempts to make C.P. 2 more current instead of stale, as I referred to, and how this impacts people, which is a daily media concern, and a concern of everybody else's right, now if we had an inflation rate of 1 percent for the January-March quarter of 1981, from the April-to-June quarter of 1981 and from the July-to-October of 1981, and then we had high inflation of, say, 15 percent for the following two quarters, the recipient would be undercompensated for current happenings.

I am saying that our lag time is such a long lag time that it does not reflect a true rate of inflation—and it injures at both ends. If we do get into another inflationary period, the current method will hurt those beneficiaries of index programs. Conversely, it is also true that when inflation is going the other direction, that the compensation should be weighted to reflect those current months.

Mr. TURE. Yes. I think your point is very well taken indeed. Just to generalize it, the more current you can make the index, the better off you are going to be. When you try to average the index observations over an extended period of time, the greater the degree will be and the greater the distortion is likely to be.

Senator MATTINGLY. As an economist, what sort of an impact do you think the Government support of this index as an official rate of inflation when it clearly has problems, what that has upon the economy, especially the unprotected working sector of the economy, which is the majority that doesn't get compensated by Federal indexation.

Mr. TURE. The adverse impact is likely to come about because of at least at one time or another in the past, there has been a perception throughout the policymaking community that if compensation costs advance rapidly because of inflation, and you pursue a monetary policy which is "restrictive"—I put quotes around the word—that that is likely to produce unemployment and that, therefore, it is necessary to accelerate the expansion of the money stock more rapidly than otherwise. What that does, therefore, is to validate the upward thrust of labor costs from having indexed them.

We do not have to have a monetary policy of that character. I would fervently hope we have learned enough lessons, all of us, to refrain from pursuing a monetary policy with that kind of dimension in it.

On the contrary, what we ought to do is to have the monetary authority, making it very clear to the rest of the world, that we are going to go on a very slow, very steady, undeviating course of monetary expansion, and that if people make bad, ill-advised bargains in the private sector, those bargains are not going to be validated by an untoward monetary expansion.

Now, if that were to happen, I think we would minimize, one, the upward thrust, the unnecessary and excessive thrust, of COLA adjustments in labor contracts. I think people would perceive that they are simply transferring their compensation in terms of form and from one pocket to another rather than really increasing the aggregate amount in real terms. And they would perceive that in fact they would be doing so if they went more vigorouly after cost-of-living adjustments at the peril of loss of employment. I think we would have a more realistic and better informed world.

Senator MATTINGLY. I am very interested in today's Wall Street Journal. I think it sort of gives us hope that the upward cushion of inflation may have ended. We won't have to worry about the COLA opinions very much longer. Hopefully we are heading in the right direction there.

Mr. TURE. You have heard of a prudent man. That would be the imprudent man's approach to public policy.

Senator MATTINGLY. You are right.

I want to come back to something you said which impressed me, and that I am also concerned about. We must consider—I am not sure how we would go about finding out—what is appropriate to be indexed and what's not to be indexed. That is a very important question, because I think, as you do, the Government has a responsibility to create a CPI and the application of a COLA for some programs. But as I said, we have 44 programs, sitting here, that we know are indexed. We also have 40 others. We therefore must reevaluate, which should and which should not be indexed. Do you have any ideas on the outline of how we should go about that?

Mr. TURE. As I indicated going in, I am overawed by the magnitude of the programs that are now indexed. I would think that, to repeat my earlier observation, one of the very first things that should be undertaken is a careful and very rigorous analysis of what in fact are the appropriate objects for indexing and what benefits and costs are incurred in doing so.

I think there is a fairly obvious case to be made for indexing compensation contracts. That means all parts of the compensation contract, the current flows to the employee as well as that part of the compensation that will be paid to him as retirement benefits. Indeed, throughout the economy you have proceeded in that direction, I don't think to any particular harm.

But I think that is quite a different story from the notion of indexing payments made and doing so on an automatic basis as for payments made on other kinds of services. That I think you have to look at.

What it suggests to me is there is an effort to have the Federal disbursement process ignore what is going on in markets. Indexing, after all, sort of says let's forget about relative prices and let's look at the price level only. But this economy operates efficiently, if at all, only because it is sensitive to changes in relative prices, which gives us the clue as to how we ought to shift around the use of our production capability. When we put indexing on top of that, we tend to mask the relative price changes. That makes it much more difficult for the market system to work effectively.

Senator MATTINGLY. Talking about the lag time up here, we have a lag time in the Government trying to respond. I think, as you mentioned earlier about the index needing to be sort of on an even-up basis with what is in the private sector, if we look and see some of the reactions of the private sector in contracts, et cetera, they are more related to current events than what we—that is, Congress—is doing here.

Mr. **Ture**. Yes.

Senator **Mattingly**. I think that was a good point you brought up in that respect. Maybe the Bureau of Labor Statistics ought to go out and see how firms compensate for inflation on the outside. But I appreciate your testimony this morning, Dr. Ture.

Mr. **Ture**. It has been a pleasure to be with you.

Senator **Mattingly**. I am sure we will be conversing with you more.

Mr. **Ture**. I sure hope so.

Senator **Mattingly**. Thank you.

Our next witness is Mr. Stephen Skardon from the National Association of Retired Federal Employees. Welcome, Mr. Skardon.

Mr. **Skardon**. Thank you very much, Senator.

Senator **Mattingly**. I am happy to have you here. I don't know whether you are familiar with the first hearing we had. We had the Retired Officers Association and many other associations which came before us and testified in reference to the CPI. We are trying to get broad-based opinion and seem to have gotten it. We are happy to have you here.

Mr. **Skardon**. Thank you very much.

Senator **Mattingly**. You may either read your statement or submit it for the record in condensed form, however you would like to do it.

Mr. **Skardon**. It is a short statement, so maybe what I will do is just summarize it and then any questions you have I will be glad to respond to.

Senator **Mattingly**. OK.

TESTIMONY OF STEPHEN SKARDON, LEGISLATIVE ASSISTANT, NATIONAL ASSOCIATION OF RETIRED FEDERAL EMPLOYEES

Mr. **Skardon**. Mr. Chairman, I have been the legislative representative for the National Association of Retired Federal Employees for about 6 years. While I appear obviously not retired, I have as part of my job traveled the country to talk to retirees to learn about their problems, the impact of policies that are enacted by Congress on their lives. I followed the CPI issue for the last 6 years. While I am no expert, like Dr. Norwood and Dr. Rivlin, I am certainly aware of the issues and particularly how they impact on retirees.

In keeping with your request at the opening of these hearings, I will confine my remarks to the questions of accuracy of the current CPI as a measure of inflation, the appropriateness of Congress initiating more immediate steps to change the present method of calculating the CPI, and the prospect of a special CPI for retired persons. Finally, I will speak briefly to your concerns about problems in lag time between the occurrence of inflation and the point at which index programs—especially social security and Federal retirement—are adjusted.

The central issue raised in these hearings for older Americans is the fundamental integrity of the U.S. Government in living up to commitments it has made to them during their working years. Protection of the full purchasing power of promised retirement income is the most significant component of the Federal Government's retirement policies.

Discussions on the measure ultimately used to adjust these retirement programs, the CPI, is far more significant than simply a technician's debate. For older persons it is the key to the basic livelihood of millions. In times of high inflation, an accurate CPI is the only assurance that retirees have that the standard of living they have come to rely upon in retirement will be maintained.

In evaluating the accuracy of the CPI, our association feels that it is important to look at two critical factors of performance. First, we believe that regardless of the instrument used to measure the impact of inflation on the elderly, it must be a reasonable standard to which statisticians and economists generally agree represents a fairly accurate picture of inflation. Second, it must be a standard with a relatively high degree of credibility with the public. The fact that the Bureau of Labor Statistics has announced revisions in the CPI-U and CPI-W outside of its normal cycle of making such changes underscores the significance of these two factors.

Our association understands the need for accuracy and responsible reporting of inflation in calculating the CPI. It would be difficult for us to argue against changes which clearly would move the Government closer to a more accurate index. However, we do believe that it is important for policymakers to understand that it is practically impossible for anyone to produce an index which is going to be on target 100 percent of the time.

Throughout these hearings, a number of witnesses have repeatedly referred to the current calculation of the CPI as "flawed" and "misleading." These comments suggest that it is possible for us to somehow manufacture an index which is not in some way flawed and, indeed, represents a perfect picture of changes in our standards of living as a result of inflationary pressures. This, of course, is impossible; or, if it is possible, would require some of the most elaborate and sophisticated hair-splitting imaginable.

These notions do a great disservice to the elderly and only serve to undermine the credibility of Government programs upon which they rely for their retirement income. Any CPI is going to be flawed in some respect. There will always be inaccuracies for critics to seize upon. The point is that the best index we can hope to achieve is one which over a period of time gives us a reasonably clear picture of inflation with a minimum of eccentricity.

In short, our association believes that the current method of calculating the CPI has been fair and reasonable. Yet we support periodic revisions of its method of calculation first, to achieve greater accuracy, but more significantly to promote continued public and political support for the use of the CPI in adjusting retirement incomes.

Mr. Chairman, this leads to a second question you have raised on the desirability of revisions in the current CPI-U and CPI-W on a more immediate basis than that planned by the BLS in the next 3 years.

Even though the retirees I represent would probaby gain monetarily by a more immediate shift to an index with a rental equivalence component, we feel such a change would be precipitous and possibly establish a dangerous precedent for future revisions of the CPI.

In the past, BLS has wisely avoided too frequent revisions of its method of calculating the monthly CPI. Dr. Norwood has already mentioned that normal revisions take place on a 10- to 12-year cycle. This is a very good practice, one which has been violated by the changes planned for 1983 and 1985. Changes in the method of calculating the CPI inevitably inspire suspicion and anxiety among persons who depend on programs indexed by the CPI. In some cases, I would agree that these suspicions are justified. The current poisoned atmosphere of budgetary politics suggests to retirees that decisions on technical adjustments in the CPI are being made more out of a desire to cut retirement benefits than on substantive merit.

I might add here, going back to the 10- to 12-year cycle Dr. Norwood mentioned, the reason for that cycle, or that long length of time, is to allow eccentricities in the CPI to work themselves out. We have talked a lot about the housing component being an overcompensation that has been caused by the unusually high interest rates over the past few years. What is predicted now is these interest rates will be coming down and we will have undercompensation in these programs. Because we have a 10- to 12-year cycle to work with over the course of that time, the CPI we believe will represent a more accurate picture in the long run.

We are convinced that because of mounting political pressure on BLS, it had to announce some kind of revision of the housing component of the CPI in order to preempt congressional action. It is to the credit of the Bureau that it allowed a healthy period between the time that the revisions were announced and the time at which they were to be implemented. This "grace period" is most important in that it gives retirees an opportunity to understand proposed changes and the impact that these changes will have on their retirement incomes. This grace period is an all-important step in protecting the credibility and public support of the CPI and the Federal programs which utilize the index as their instrument of indexation.

Mr. Chairman, we have suggested a third area of concern in these hearings by expressing your interest in a special CPI based exclusively on the consumption patterns of the elderly. Such an index would be used to adjust Federal retirement programs like social security and Federal retirement in lieu of the current CPI-W. Our association, along with all the other major retirement groups in the country, has supported this idea for a number of years. BLS has stated in congressional hearings that it does have the capacity to develop such a CPI and is willing to begin an experimental effort if so instructed by Congress. Our association urges you and your colleagues to take such an action as soon as possible.

The basis for establishing a special CPI for older Americans is that relative to their younger counterparts, elderly persons spent greater portions of their incomes on basic-core necessities—food, fuel, utilities, and medical care. The costs of these items have risen at rates far in excess of the overall CPI.

In a study released in 1980, Data Resources, Inc., stated: "Since 1970, the cost-of-living for the elderly has risen faster than the cost-of-living for non-elderly consumers—increasing at an annual rate of 8.4 percent for the elderly compared to 7.2 percent for the non-elderly."

In a study published in the Social Security Bulletin in January 1981, similar conclusions were reached, verifying the idea that certain key expenditure components which have risen at rates exceeding the CPI are not weighted sufficiently in the calculation of the CPI–W to accurately reflect the consumer patterns of older persons.

I was interested in your chart which demonstrated the effect of the housing component in the last few years on index programs. It would be interesting to see similar charts showing the undercompensation that has resulted from insufficient weighing of such items as food, fuel, utilities, and medical care.

It should be noted that possible distortions created by the housing component can work both ways. For example, in 1980 fluctuating rates of mortgage interest rates, which are included as part of the housing component, actually held the CPI–W at artificially low levels, thereby limiting cost-of-living adjustments in indexed programs.

As an alternative to the CPI, some of the news media and Government have advanced suggestions to tie increases in Federal programs for the elderly to increases in wages or other arbitrary standards not directly linked to the rate of inflation.

The very idea of equating earned annuity income of retirees with that of persons still actively participating in the work force is absurd. It is an apples-and-oranges proposition. Very few active workers have careers which are not marked by promotions and merit increases in pay beyond that of the basic cost of living. Active workers are also able to take second jobs, work overtime, or even change jobs to generate additional income. The income of the elderly is basically fixed. Most are unable to return to the work force to earn additional income during hard economic times.

Furthermore, for those who are able, working in old age often means reductions in pension and social security income. It can also mean the loss of special tax benefits and eligibility for other social programs designed to assist them.

One important point often overlooked in these discussions about wage indexing is that the income of the average worker drops dramatically at the time he retires. Today, the income of the average worker is below that of his final salary while he was working.

Mr. Chairman, it is my understanding that you and others are interested in exploring possibilities of revising the method of awarding cost-of-living adjustments in a fashion which more adequately addresses the problem of lag time between the occurrence of inflation and the point at which retirement programs are adjusted to reflect inflationary increases. Until there is a more concrete proposal, it is difficult to make a firm judgment about it.

Our concern is that whatever formula is used ultimately reflects 100 percent of any changes in inflation and that such a formula maintain the full purchasing power of retirement benefits.

As you know, last year the Federal retirees' COLA was reduced from a semiannual to an annual frequency. This was unfortunate in that it prolonged the lag time about which you are concerned. Indeed, the 1979 Social Security Advisory Council concluded that annual COLA's in social security were actually contributing to a gradual erosion of benefits and urged an upgrading of that system's COLA to twice a year. During the 1980 Presidential campaign, Candidate Ronald Reagan won significant support from Federal retirees when he stated flatly that the semiannual COLA adjustment in Federal retirement benefits was appropriate and should be continued in a Reagan administration.

Senator MATTINGLY. Excuse me. I have 7½ minutes to go to a vote right now. Would you mind if we recessed for 10 minutes so I can go vote and come back and we will continue.

Mr. SKARDON. That is fine.

[Brief recess.]

Senator MATTINGLY. The hearing will continue.

Mr. SKARDON. That was the end of my statement, Mr. Chairman.

Senator MATTINGLY. OK. Thank you.

I know that you agree with our debate over the CPI that we really do need a more accurate method of calculating the CPI so we can index Federal programs. It was sort of the consensus at the prior hearings that the housing component was a distorted statistic of the actual measure of the cost of living for housing. What does your group feel about changing that factor in there? What changes would you suggest to correct that distortion?

Mr. SKARDON. We have no problems with changing the housing index. Clearly it is one of the more irratic components of the CPI. But if that is going to be changed, we feel it should be accompanied by changes in the other principal items I mentioned before.

Senator MATTINGLY. I agree with you.

I heard some testimony, not from you but from prior witnesses, that if we went to "U," it could conceivably be higher. Because the main thing, I agree with you, is for it to be accurate, irrespective of what it would do to the up or down part of it, the evaluation of it.

Mr. SKARDON. That is true.

Senator MATTINGLY. One thing I, of course, am interested in is the concept of the special retirees index, not because you are sitting here representing retirees, but as one that would really reflect the unique cost of living for the elderly. I just want to get a hard commitment, yes or no, that you would support then a retirees index.

Mr. SKARDON. Absolutely.

Senator MATTINGLY. Really, other than that, knowing full well we have an incorrect, flawed CPI, that we understand one will never get 100 percent correct numbers, however—especially in the Federal Government will anything ever be 100 percent—but to make it "more correct," that is the goal of these hearings. Congress must either legislate or request BLS to institute those things at a more rapid rate to incorporate these good changes. So whether it will be going to CPI-U—which I think we should immediately do—or whatever, just from the standpoint of being fair we must change the CPI. You know, you mentioned something about the anxiety and suspicion among people out there. I think that there is less of that than what maybe people east of the Potomac feel, that the people west of the Potomac actually understand what is going on. I think maybe you probably are getting some input from your people nationally on that, aren't you?

Mr. SKARDON. Sure. I might add, apparently you spoke to one of our chapters in Savannah and very adequately explained what you were doing in these hearings. I immediately got a letter asking if you were telling the truth. [Laughter.]

I think there is a great deal of suspicion even when the person involved is there face-to-face explaining exactly what is going on. I think timely changes are important in maintaining public support for index programs like social security.

Senator MATTINGLY. It really gets down to—I probably would like to change the index faster than some other people. The question is, If you have a flawed figure, would you want it corrected? The answer always comes back "yes," no matter whether it is a veterans group or retired employees or no matter who it may be, that yes, if it is inaccurate, yes, we do want it corrected. I think that the reliability of that figure ought to be made more certain and more accurate. That is the goal of it.

I think the message is getting out fairly well. The input that we get once my plan is explained, and they understand it, is supportive.

I appreciate your help in this matter, too.

Mr. SKARDON. Sure. Again, the timing factor is important, though.

Senator MATTINGLY. Right. I wish it could happen yesterday. As I told the prior witness, making a change in the Federal Government is like dragging a bag of rocks around sometimes. But that needs to be changed also, the rate of action of the Federal Government. The Federal Government should be able to act faster and be more responsive than it actually is, whether it is on the side of overcompensation or on the side of undercompensation. If it is in error, it needs to be changed and let's not wait for the millenium.

Mr. SKARDON. Of course, there are a lot of people like me who are paid to slow it down. [Laughter.]

Senator MATTINGLY. To slow down what?

Mr. SKARDON. The actions of the Federal Government.

Senator MATTINGLY. Me, too. I am paid to slow it down, too. I am paid to make it right. What is happening is that it hasn't been right. I don't mean just the CPI, but many things.

The thing I'm trying to do is to try to correct it, whether it be a cost-of-living adjustment, whether it be CPI, or programs that should not be indexed or money misspent or not spent. That is the goal. I think together we can make it happen.

Thank you.

Mr. SKARDON. Thank you.

Senator MATTINGLY. I appreciate your testifying.

[Mr. Skardon's prepared statement follows:]

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STATEMENT OF
THE NATIONAL ASSOCIATION OF RETIRED FEDERAL EMPLOYEES
BEFORE THE
COMMITTEE ON GOVERNMENTAL AFFAIRS
SUBCOMMITTEE ON CONGRESSIONAL OPERATIONS AND OVERSIGHT
UNITED STATES SENATE

THURSDAY, MAY 13, 1982

Mr. Chairman and Members of the Subcommittee, I am Stephen Skardon, Legislative Representative of the National Association of Retired Federal Employees. We have a national membership of 500,000, representing the interests of retired Federal employees, their spouses and survivors. Our President, L. J. "Lud" Andolsek is presently out of the city and asked that I convey to you his appreciation for your work on this issue. We welcome the opportunity to comment today on concerns raised about the accuracy of the Consumer Price Index and the impact of that index on the income of older Americans.

Mr. Chairman, in keeping with your request at the opening of these hearings, I will confine my remarks to the questions of accuracy of the current CPI as a measure of inflation, the appropriateness of Congress' initiating more immediate steps to change the present method of calculating the CPI, and the prospect of a special CPI for the elderly. Finally, Mr. Chairman, I will speak briefly to your concerns about problems in lag time between the occurrence of inflation and the point at which index programs -- especially Social Security and Federal Retirement -- are adjusted.

The central issue raised by these hearings for older Americans is the fundamental integrity of the United States Government in living up to commitments it has made to them to maintain the full value of their retirement incomes -- specifically, in social security and the staff retirement system of the Federal Government. Protection of the full purchasing power of promised retirement income is the most significant component of the Federal Government's retirement policies.

Champion of Retired Federal Employees

It cannot be otherwise. Therefore, discussion on the measure ultimately used to adjust these retirement programs -- the CPI -- is far more significant than simply a technician's debate; it is the key to the basic livelihood of millions of older Americans. In times of high inflation, an accurate CPI is the only assurance retirees have that the standard of living they have come to rely upon in retirement will be maintained.

In evaluating the accuracy and effectiveness of the CPI in Federal retirement programs, our Association feels it is important to look at two critical factors of performance. First, we believe that, regardless of the instrument used to measure the impact of inflation on the elderly, it must be a reasonable standard to which statisticians and economists can generally agree represents a fairly accurate picture of inflation. Secondly, it must be a standard with a relatively high degree of credibility with the public. The fact that the Bureau of Labor Statistics (BLS) has announced revisions of the CPI-U and CPI-W outside of its normal cycle of making such changes underscores the significance of these two factors.

Our Association understands the need for accuracy and responsible reporting of inflation in calculating the CPI. It would be difficult for us to argue against changes which clearly would move the government closer to a more accurate index. However, we do believe it is important for policy makers to understand that it is practically impossible for anyone to produce an index which is going to be on target 100 percent of the time. Throughout these hearings, a number of witnesses have repeatedly referred to the current calculation of the CPI as "flawed" and "misleading." These comments suggest that it is possible for us to somehow manufacture an index which is not in some way flawed and, indeed, represents a perfect picture of changes in our standards of living resulting from inflationary pressures. This is impossible, or if it is possible would require some of the most elaborate and sophisticated hair splitting imaginable.

These notions do a great disservice to the elderly, and only serve to undermine the credibility of government programs which rely on the CPI as the sole measure by which they are periodically adjusted. Any CPI is going to be flawed in some respect. There will always be inaccuracies for critics to seize upon. The point is that the best index we can hope to achieve is one which over a period of time gives us a reasonably clear picture of inflation with a minimum of eccentricity.

In short, our Association believes that the current method of calculating the CPI has been fair and reasonable. Yet, we support periodic revisions of its method of calculation first, to achieve greater accuracy, but more significantly, (as is the case with the 1983 and 1985 changes) to promote continued public and political support for the use of the CPI in adjusting retirement incomes.

Mr. Chairman, this leads to a second question you have raised on the desirability of revisions in the current CPI-U and CPI-W on a more immediate basis than those planned by the BLS in the next three years.

Even though the retirees I represent would probably gain monetarily by a more immediate shift to an index with a rental equivalence component, we feel such a change would be precipitous, and possibly establish a dangerous precedent for future revisions of the CPI.

In the past, BLS has wisely avoided too frequent revisions of its method of calculating the monthly CPI. Dr. Norwood has already mentioned that normal revisions take place on a ten to twelve year cycle. This is a very good practice; one which has been violated by the changes planned for 1983 and 1985. Changes in the method of calculating the CPI inevitably inspire suspicion and anxiety among persons who depend on programs indexed by the CPI. In some cases, I would agree that these suspicions are justified. The current poisoned atmosphere of budgetary politics suggests that decisions on technical adjustments in the CPI are being made more out of a desire to cut retirement benefits than on substantive merit.

I am convinced that because of mounting political pressure on the BLS, it had to announce some kind of revision of the housing component of the CPI in order to preempt Congressional action. It is to the credit of the Bureau that it allowed a healthy period between the time that the revisions were announced and the time at which they were to be implemented. This "grace period" is most important in that it gives retirees an opportunity to understand proposed changes, and the impact that these changes will have on their retirement incomes. This grace period is an all-important step in protecting the credibility of the CPI and the Federal programs which utilize the index as their instrument of indexation.

Mr. Chairman, you have suggested a third area of concern in these hearings by expressing your interest in a special CPI based exclusively on the consumption patterns of elderly persons: Such an index would be used to adjust Federal retirement programs like social security and Federal retirement in lieu of the current CPI-W. Our Association, along with the other major retirement groups in the country, has supported this idea for a number of years. BLS has stated in Congressional hearings that it does have the capacity to develop such a CPI, and is willing to begin an experimental effort if so instructed by Congress. Our Association urges you and your colleagues to take such an action as soon as possible.

The basis for establishing a special CPI for older Americans is that, relative to their younger counterparts, elderly persons spend greater portions of their incomes on basic core necessities -- food, fuel and utilities, and medical care. The costs of these items have risen at rates far in excess of the overall CPI.

In a study released in 1980, Data Resources, Inc. stated: "Since 1970, the cost-of-living for the elderly has risen faster than the cost-of-living for non-elderly consumers -- increasing at an annual rate of 8.4 percent for the elderly compared to 7.2 percent for the non-elderly."

In a study published in the SOCIAL SECURITY BULLETIN (January 1981) similar conclusions were reached, verifying the idea that certain key expenditure components which have risen at rates exceeding the CPI, are not weighted sufficiently in the calculation of the CPI-W to accurately reflect the consumer patterns of older persons.

It also should be noted that possible distortions created by the housing component can work both ways. For example, last year fluctuating rates of mortgage interest rates, which are included as part of the housing component, actually held the CPI-W at artificially low levels, thereby limiting cost-of-living adjustments in indexed programs. This situation was noted in a recent report from the Office of Management and Budget which stated: "The precipitous decline in interest mortgage interest rates that occurred in the middle of 1980 reduced inflation in the home ownership component of the CPI from a 25 percent annual rate in the first half of 1980 to two percent during the next four months."

As an alternative to the CPI, some in the news media and government have advanced suggestions to tie increases in Federal programs for the elderly to increases in wages or other arbitrary standards not directly linked to the rate of inflation.

The very idea of equating earned annuity income of retirees with that of persons still actively participating in the work force is absurd. It's an "apples-and-oranges" proposition. Very few active workers have careers which are not marked by promotions and merit increases in pay beyond the basic cost-of-living. They are also able to take second jobs, work overtime, or even change jobs to generate additional income. The income of the elderly is basically fixed. Most are unable to return to the work force to earn additional income during hard economic times.

Furthermore, for those who are able, working in old age often means reductions in pension income. It can also mean the loss of special tax benefits and eligibility for other social programs designed to assist elderly persons.

One important point often overlooked in these discussions is that the income of the average worker drops dramatically at the time he retires. Today, the income of the average retiree is 52 percent of that of younger persons. There is no retirement plan in the country which enables retirees to ever again recover this stunning decline in standard-of-living. Perhaps the greatest advantage of the present system of indexing is that it takes the adjustment process out of the political arena and places it in an orderly, non-partisan mechanism on which retirees can rely and plan their futures. This process has been most effective in protecting benefits while saving taxpayers millions of dollars. Analysis of the relative rates of growth in retirement programs suggests that during times of ad hoc, or less than regular adjustments, benefit increases were granted by Congress at rates far in excess of prevailing rates of inflation. For example, between 1967 and 1972, Congress increased social security benefits nearly twice as fast as the CPI.

Mr. Chairman, it is my understanding that you and others are interested in exploring possibilities of revising the method of awarding cost-of-living adjustments in a fashion which more adequately addresses the problem of lagtime between the occurrence of inflation and the point at which retirement programs are adjusted to reflect inflationary increases. Until there is a more concrete proposal, it is difficult to make a firm judgement about it.

Our concern is that whatever formula is used ultimately reflects 100 percent of any changes in inflation, and that such a formula maintain the full purchasing power of retirement benefits.

Under current law, both social security and Federal retirement benefits are indexed once a year. Social security benefits are indexed in July checks, while Federal retirement benefits are adjusted in April of each year. Both COLA increases are based on a preceding 12-month period of changes in the CPI-W. Both reflect 100 percent of any increases in the index. The maximum social security benefit for a couple, with the worker spouse retiring this year at age 65 is $1,093 a month (as of July 1982). The average Federal annuity is approximately $1,000 a month (marital status is not relevant, nor is an age breakdown available). The average annuity for a survivor of a Federal worker-annuitant is approximately $450 a month. The Federal retirees' annuity is fully taxable, while Social Security is tax-free.

As you know, last year the Federal retirees' COLA was reduced from a semi-annual to an annual frequency. This was unfortunate in that it prolonged the lagtime about which you are concerned. Indeed, the 1979 Social Security Advisory Council concluded that annual COLAs in social security were actually contributing to a gradual erosion of benefits, and urged an upgrading of that system's COLA to twice-a-year. During the 1980 Presidential campaign, Candidate Ronald Reagan won significant support from Federal retirees when he stated flatly that the semi-annual adjustment in Federal retirement benefits was appropriate and should be continued in a Reagan Administration.

It is difficult for our organization to understand how anything short of increasing the frequency of COLA adjustments will improve the lagtime problem. A proposal advanced by some suggests that a system which weights CPI increases closest to the time of the COLA award might help in overcoming some of the problems associated with lagtime. It is hard to understand how such a proposal would not be vulnerable to the same charge of overstating or understating the effect of inflation, as has been made against the present CPI. It also seems to evade the basic purpose of the COLA award which is to maintain the full value of retirement benefits.

Our Association is always ready to look at new options and explore the possibility of improving the current system of indexing. We would be delighted to work with you and your staff in perfecting such a proposal and analyzing its potential effects.

Thank you, Mr. Chairman and Members of the Subcommittee.

Senator MATTINGLY. Dr. Huard is vice president for taxation and fiscal policy for the National Association of Manufacturers. We are all familiar with NAM's work. I thank you for appearing before us today.

Before we get on with this, I am sure that we will be interrupted somewhere along the line.

Mr. HUARD. I understand, sir.

Senator MATTINGLY. Be my guest. Go right ahead.

TESTIMONY OF PAUL R. HUARD, VICE PRESIDENT FOR TAXATION AND FISCAL POLICY, NATIONAL ASSOCIATION OF MANUFACTURERS, ACCOMPANIED BY GORDON RICHARDS, DIRECTOR OF ECONOMIC ANALYSIS

Mr. HUARD. Thank you, Mr. Chairman. I would like to note I am accompanied by Mr. Gordon Richards, director of economic analysis.

What I would like to do is submit my prepared statement for the record and summarize my remarks, and then Mr. Richards and I will hopefully be able to address any questions you may have.

Let me open by stating NAM's view that the CPI has been a misleading and inaccurate measure of inflation. Specifically, we think there are two major problems with the CPI. First, because it uses the fixed weight sample technique, the CPI does not take into account long-term changes in consumer spending patterns.

In this regard, I would like to state my agreement with Dr. Ture's comments and particularly those where he pointed out the CPI also takes into account certain items like infant and toddler clothing which for certain uses such as indexation of retiree benefits may not be appropriate. That is another problem.

Second, and perhaps more importantly in terms of the past distortion of the CPI, the CPI has included distorted housing costs because of the use of mortgage interest rates, in effect as a proxy for estimating the cost of housing. We think it is fairly obvious mortgage interest rates are an inaccurate measure of actual housing costs, much less housing costs throughout the economy, particularly since over 50 percent of the economy continues to rely on rental housing.

A comparison of the CPI and the more widely based GNP deflator underlines the inadequacy of the CPI as a measure of inflation rates in general. As table 1 to my statement indicates, throughout the post war period, the CPI and the GNP deflator have frequently exhibited substantial divergence.

For instance, in 1946-47, the GNP deflator rose much more rapidly than the CPI during the inflationary explosion in the immediate aftermath of the Second World War. On the other hand, the Korean war inflation was clearly more acute when measured by the CPI than by the GNP deflator. During the low inflation period of the 1950's, the CPI actually seems to have understated the rate of inflation. Throughout the 1960's, there was little significant divergence between these two indices.

Although the CPI was less than 1 percentage point ahead of the GNP deflator in 1976-78, in 1979-81 the effects of the distortions in the CPI became particularly visible. In 1979, the CPI rose at 11.3

percent by comparison with 8.5 percent for the GNP deflator. In 1980, the corresponding figures are the 13.5-percent rise of the CPI as against the 9 percent as measured by the GNP deflator. Clearly, as an indicator of the inflation rate, the CPI became increasingly inaccurate during the late 1970's. Moreover, during this period, much of that problem had to do solely with the home mortgage cost component.

I think that is an issue which I can testify to from personal experience. Even though, fortunately, I was not in a position of having to sell my home, I had several neighbors who were in the military and being transferred, at a time when the CPI was probably including a substantially high factor for housing cost increases. Due to mortgage interest rates being 15, 16, 17 percent, these people were selling their house at costs that were less than what comparable houses had sold for the year before. So actually the houses had gone down in value if you just look at market value. Yet, according to the CPI, housing was on the rise.

I would like to move on now to the issue of indexation of payments.

The indexation of payments under many Federal programs, in accordance with fluctuations in the CPI, has placed upward pressure on Federal spending. According to CBO estimates, each percentage point increase in the CPI is associated with about $2 billion in additional Federal spending.

However, it is to be emphasized in this context that the overstatement of inflation by the CPI in and of itself represents only a comparatively small percentage of the total increase in Federal spending caused by "uncontrollable" categories, such as indexation of transfer payments. To a large degree, the growth in the uncontrollable portions of the Federal budget has been due to indexation in and of itself—in other words, the fact that the payments are indexed—and not so much to the CPI per se.

For this reason, we think that the issues of improved budgetary control and entitlement reform should be differentiated from the issue of CPI reform. At the present time, the indexation of transfer payments to the CPI has led to what we believe is an unnecessary politicization of the issue of CPI reform. To the degree that this issue could be separated from the issue of controlling overall Federal outlays, this will facilitate CPI reform, since the issue will be less overtly politicized when the level of transfer payments is no longer directly dependent on the CPI itself.

On another point you requested we address, with respect to the issue of how lags in the computation of cost-of-living adjustments for Federal transfer payments based on the CPI affect the final costs to the Government, we think there is probably no satisfactory means of resolving this question. Critics of the current system correctly pointed out that the use of the first quarter to first quarter percent change in the CPI as the basis for indexation will result in a 7.4-percent increase in benefit payments in July 1982, whereas the short-term inflation rate is in the area of 3 to 4 percent.

However, there is no evidence that going over to another means of indexation based on the CPI—for instance, the CPI on a year-to-year, or a December-to-December basis—would save any significant amount of money. Because of the extreme short-term volatility of the CPI itself, there is no way of predicting what implications use of the year-to-year or December-to-December indexes would have on future cost-of-living adjustments.

As an illustration of this point, there have been substantial deviations between the year-to-year and December-to-December CPI's. The CPI on a year-to-year basis increased more rapidly than December-to-December in 1975, 1976, 1980, and 1981 and less rapidly in 1974, 1977, 1978, and 1979.

So, in short, changing the system of indexation from the CPI at present levels to some other basis would not necessarily be preferable from the standpoint of realizing budgetary savings. While some money might be saved in 1982, when the inflation rate is decelerating, it is likely that the reverse would be the case during the period when the inflation rate is accelerating. It would probably average out over time.

Leaving aside the issue of cost-of-living adjustments, there are some other problems associated with the CPI to which we would like to draw attention. In particular, distortions in the CPI can lead to serious policy errors because they create a misleading picture of inflationary developments. Specifically, the exaggeration of the inflation rate by the CPI probably contributed to the policy mistakes that led to the 1980 recession.

In October 1979, one of the main objectives of the new Federal Reserve Policy was to achieve a deceleration in the inflation rate. Nevertheless, during the first 3 months of 1980, the CPI accelerated to over 17 percent. The apparent inability of tighter money to halt the surge in inflation led to the imposition of credit controls in the second quarter of 1980, which caused real output to fall at an annual rate of 9.9 percent, the steepest quarterly rate of decline since 1946. In retrospect, however, we believe the imposition of that credit controls program emerges as a major policy error, which was all the more egregious since it was completely unnecessary.

Using the GNP deflator as a measure, the inflation rate in the first quarter of 1980 was 9.3 percent, not the 17-percent range reported by the CPI. In short, the acceleration of the CPI in early 1980 appears to have been due solely to "one-time-only" factors, such as the decontrol of domestic oil prices and the distortion of the housing component of the CPI by high interest rates in that particular quarter. Neither of these would have had any permanent effect on the inflation rate, with the result that the credit controls were implemented to forestall a danger that was more illusory than real.

I would like to conclude by summarizing my recommendations with regard to the issue under discussion this morning.

NAM supports the reform of the CPI proposed by the BLS. We believe the transition to a CPI where the housing component is based primarily on a rental equivalency measure will insure that future inflation rates as reported by the CPI will be more realistic. We also support the gradual phase-in of the new index proposed by the BLS since this will minimize any distortions caused by an abrupt transition to a new CPI.

NAM further recommends that the issue of indexation of Federal transfer payments or program payments be resolved by considering going over to some alternative index. For instance, in earlier testimony presented to the House Budget Committee on the issue of entitlement reform, we suggested 75 percent of the lower of wage or price increases as a possible technique for indexing transfer payments. However, we would be willing to consider supporting any alternative means of indexing apart from the CPI if this would result in equitable results and hopefully substantial budgetary savings.

The rationale for use of the alternative index is twofold. On the one hand, if it is more realistic, it may result in substantial budgetary savings because the cost of inflation as measured at least by the cost-of-living adjustments will not be overstated. Also, we think that taking it off the CPI, where it presently is, might have the highly useful advantage of depoliticizing the issue because since then the cost-of-living adjustments would no longer be dependent on the CPI. This would probably permit the transition to a more realistic CPI.

That concludes my remarks this morning, Senator. We would be happy to answer questions.

Senator **MATTINGLY**. Thank you very much.

I have some questions here, but you have answered half of them already, which is great. I was going to make a comment that some people were not supportive of changing to the CPI-U immediately for indexed programs. Their argument is that they hope that the present incorrect CPI will undercompensate Federal programs as the rate of inflation declines. You mentioned we should go to the CPI-U. You said it is a more accurate measure. I am glad to hear you say that. And also that NAM would support other propoasls of either having an alternative index such as the lower of prices or wages; or 75 percent of the CPI, which is similar to my piece of legislation which would use 85 percent of the CPI, and the lower of prices or wages, which I assume you all also would support.

You agree the CPI has misstated the rate of inflation for the many indexed programs. As you point out, the Carter credit controls are one example of bad public policy that has resulted because of the confusion created by this inaccurate index. What other policy problems have you seen created because of Congress either misapplying or misusing this index?

Mr. **HUARD**. I think my economist, Mr. Richards, might be able to detail those, Senator.

Mr. **RICHARDS**. Thank you.

I would like to point out some policy mistakes seem to have been made during the period of the Nixon wage-price controls, 1971–74, partially as a result of the understatement of inflation by the CPI at that time. The initial phases of the Nixon controls—that is, the freeze in 1971 followed by the phase 2 controls in 1972—were considerably more effective against the Consumer Price Index than they were against the GNP deflator.

For instance, the freeze lowered the deflator from about 5 percent to only 3.3 percent, whereas consumer prices were virtually level for a 3-month period. Under the circumstances, policymakers appear to have been lulled into a false sense of security by the fact that the CPI had fallen to a very low level. There was a pervasive belief at the time that the battle against inflation had already been won and that the country could go over to a more stimulative demand management policy without a rise in inflation.

In retrospect, this appears to have been substantially in error. If you look at 1973-74, there was a massive increase in inflation at the time. To a large degree, the excessive stimulus that was applied in 1972 may reflect the fact that the CPI was seriously understating real inflationary trends at the time.

Another issue I would like to draw your attention to, which of course is not necessarily a public policy issue, is that some cost-of-living increases in the private sector have involved indexation to the CPI, although this has not been true of all cost-of-living increases in private wage contracts.

During the late seventies, those wage increases that were in fact linked to the CPI tended to raise wages above their free market levels because the CPI was so far ahead not only of the real rate of inflation but also ahead of the average rate of increase in the wage index as determined by free market relations between labor and management.

As a result of that, the increase in wages through the indexation to the CPI probably contributed to the constriction of the profit margins that took place.

A further factor which contributed to the constriction of profit margins was the fact that the Carter wage-price guidelines were in force during the late seventies and since there was widespread compliance with both the wage and price standards, the implication is that prices were lower in relation to wages and that all of the improvement in inflation that did take place was achieved by squeezing profit margins.

For this reason, I think we can legitimately claim that the exaggeration of inflation by the CPI has had a variety of adverse effects. Thank you.

Senator MATTINGLY. Thank you.

Right now we have policies being created for next year, for the next fiscal year's budget, on this area of the budget that CPI impacts. How important do you feel it is for this Congress to try to address these problems that we have been trying to highlight?

Mr. HUARD. I think it is absolutely essential for the Congress to address the issue of indexation of all program payments. Again, this is a much bigger problem than just reforming the CPI. Reforming the CPI is an issue which has implications not just for the Federal budget but also as we discussed, for making correct policy decisions—going back to our example of the Carter credit controls and things like that.

But the issue of indexation itself is really a much broader and really a separate issue. I think it is one that the Congress absolutely must address if we are ever to get the Federal budget under control. I usually try to avoid getting on soapboxes, but one of the things that concerns me when groups get up here and their testimony on things like the CPI is addressed to the inaccuracies of the CPI and granting full protection to a certain class, whether it is retirees or somebody else, at a time when the economy is in a distressed state that it is in, I think that the issue is not granting full protection to a specified class of people covered by a Federal program or Federal transfer payment system like social security. The issue is what is an equitable manner of resolving our overall budgetary problems in a way which fairly distributes the sacrifice.

For instance, I suggested in the testimony on entitlements going to some type of system which would be geared to 75 percent of the lower of wages or CPI increases. That is not full protection, but it is substantial protection. It implies this is a group that has to share the sacrifice.

The Senate Budget Committee's proposal, as reported out, calls for $95 billion in revenue increases. We are under no illusions that the business community is going to be asked to shoulder a substantial portion of the revenue increases. We are willing to do it. The NAM has supported the Domenici package, and we are going to do everything we can to see that members of our association communicate that support to Members of the Senate.

We think also the reason we are supportive is it does call for sacrifice across the board—$40 million in social security, $33 million in other entitlements. We think it is a fair and balanced approach. We think the item of indexation has to be considered in that light.

Senator MATTINGLY. As I say, there are 44—I don't know whether you were here originally—there are 44 indexed programs and there are over 40 other programs that are also indexed, other than those, in some fashion, by the CPI. We—not really, we—but those who came before us created this monster that has now got to be changed.

I think Dr. Ture made the comment, which I support that Congress has to decide what is appropriate and what is not appropriate to index. Obviously indexation is out of control. I hope that NAM will stick with us, because I think that each one of those 44 programs right there, plus the additional 40, represent some sort of constituency that probably brings political pressure upon 535 people in this Congress. We need some help to preserve the taxpayers out there.

I think if the taxpayers, which I hope eventually get this information, if they knew this Federal Government is indexed like this and all of these special interest groups have indexed programs, they would probably all come en masse across the Potomac to end this practice.

Mr. HUARD. We couldn't agree more, Senator. Our position is that we have to look at all of these programs and determine what our priorities are, which ones are more important. If we can't afford them all, I think it is then clear we can't afford to pay for them in the style we have been paying for them, with just automatic adjustments. We have to determine which ones are more important and continue those.

Senator MATTINGLY. Right. I think looking historically, when we started the indexing process, we could pin the tail right on the donkey. Thank you very much.

Mr. HUARD. Thank you, Senator.

[Mr. Huard's prepared statement follows:]

STATEMENT
OF
PAUL R. HUARD
ON
REFORM OF THE CONSUMER PRICE INDEX
ON BEHALF OF
THE NATIONAL ASSOCIATION OF MANUFACTURERS
BEFORE THE
SUBCOMMITTEE ON CONGRESSIONAL OPERATIONS AND OVERSIGHT
OF THE
SENATE COMMITTEE ON GOVERNMENTAL AFFAIRS
MAY 13, 1981

My name is Paul R. Huard. I am Vice President for Taxation and Fiscal Policy of the National Association of Manufacturers. NAM represents nearly 12,000 member firms who account for nearly 80% of the nation's industrial output and 85% of the nation's industrial workforce. I am pleased to be here to present NAM's views on reform of the Consumer Price Index.

INTRODUCTION

The issue of reform of the Consumer Price Index (CPI) can be addressed on two levels. On the one hand, there is the purely technical issue of the adequacy of the CPI as a measure of inflation. For a variety of reasons, this index appears to be seriously flawed and gives a misleading picture of actual developments in the economy. On the other hand, the issue of CPI reform has recently been complicated by the fact that many federal transfer payment programs are indexed to the CPI, which has unnecessarily politicized what should be an essentially technical issue. As a result of indexation, the inherent distortions in the CPI have put upward pressure on federal spending on entitlement programs. Nevertheless, the magnitudes of the budgetary savings that can be realized solely through technical reform are comparatively minor. For this reason, although NAM fully supports reform of the CPI, the issue of indexation must be resolved separately, and should be evaluated in terms of the needs of fiscal policy as it relates to the economy.

THE ADEQUACY OF THE CPI AS AN INFLATION INDICATOR

As it is presently constructed, there are a series of problems with the CPI which make it an inaccurate measure of underlying inflationary trends.

Defects in Construction. The CPI was never intended to serve as a measure of the overall inflationary trend throughout the economy. Rather, it represents the cost of a fixed sample of commodities which putatively approximate the spending patterns of the modal American consumer. Nevertheless, the use of the CPI has become sufficiently widespread that it is frequently taken as an indicator of the actual rate of inflation. In reality, the method by which the CPI is calculated makes it inaccurate not only as an overall measure of inflation, but also as an indicator of what it was ostensibly designed to measure, i.e., the cost of living for consumers. Here, there are two defects.

First, the CPI is calculated as a fixed-weight index of the selected sample of commodities, in essence the Laspeyres system. The Laspeyres technique for the construction of price indexes involves a system of fixed weights based on the relative quantities of the commodities in the sample purchased by consumers during the base year. The advantage of the Laspeyres technique is that it tends to filter out short run volatility caused by seasonal and near term changes in the relative weights of each component of the sample; in other words, the index is a consistent measure of a fixed sample. However, the short term advantages of the Laspeyres technique may be outweighed by its longer term disadvantages. Any number of factors -- demographic trends, real GNP growth rates, and changes in the relative prices of particular commodities -- can induce longer term shifts in the pattern of consumption, which are not reflected in the CPI unless the weights are periodically readjusted. For instance, the maturation of the generation born duing the 1950s has increased the relative percentage of disposable income spent on housing and consumer durables. The very high rates of GNP growth during the 1960s led to increased spending on travel and luxury items. The changes in relative energy prices in 1973-74 and 1979-80 have induced a shift into less energy-intensive goods and services.

None of these factors have been adequately picked up in the CPI because of the fixed-weight system. Although on average the magnitudes of the rate of change in the CPI associated with relative price changes and substitution effects may not be particularly large in and of themselves, the overall result has been for the CPI to give a misleading and inaccurate picture of actual developments both in the price sector and in personal consumption patterns.

Difficulties inherent in the Laspeyres technique have led economists to use a variety of other systems for computation of price indexes. Only ten years after the Laspeyres technique was invented, the alternative Paasche technique was developed in 1874. Like the Laspeyres system, the Paasche system computes an index as a ratio of weighted aggregates, but with the important difference that it gives added importance to current period expenditures in the determination of the weights: here, the weights are calculated by relating actual current period expenditures in the numerator of the index equation to base period weights in the denominator. The advantage of the Paasche technique over the Laspeyres technique is that it picks up substitution effects caused by relative price differentials and other factors. The disadvantage, however, is that because it does take these changes into account, the Paasche technique is likely to understate the actual rate of inflation. For instance if increases in relative energy prices induce a shift in consumption patterns to non-energy-intensive commodities, the

Paasche technique shifts the index weights toward non-energy-intensive products, resulting in an understatement of the contribution of the increase in energy prices to the average rate of inflation.

Ideally, the optimal price index is a geometrically weighted average of the Paasche and Laspeyres techniques. In the long term, a shift to such a system would considerably improve the reliability of alternative price indexes as measures of inflation. However, the system of weighting in the CPI has been a lesser source of possible inaccuracy than the choice of the commodities in the sample, in particular, the system for measurement of housing costs.

As is widely recognized, the CPI distorts housing costs through the use of nominal mortgage interest rates as a proxy for the cost of housing. It is fairly obvious that nominal mortgage interest rates are inaccurate as a measure of actual homeownership costs, much less housing costs throughout the economy at a time when over 50% of the population continues to rely on rental housing.

Even for homeowners, nominal mortgage interest costs do not measure the real costs of housing. For instance in an inflationary environment, homeowners who take out fixed interest mortgages may experience real income gains as the value of their home equity appreciates more rapidly than the average rate of inflation for the economy, while the mortgages are repaid in depreciated currency. Furthermore, interest payments are tax deductible, which reduces the ultimate cost of holding wealth in the form of home equity. At the same time, homeowners are subject to any number of other costs which are not measured in the CPI, although they are an integral component of the cost of homeownership.

Moreover, the use of mortgage interest rates does not provide an accurate assessment of housing costs for the majority of the population that do not own homes. During the late 1970s, rental costs increased on average much more slowly than homeownership costs. There was a series of reasons for this, and in this respect it should not be overlooked that rents in many major cities are controlled.

In a wider sense, the problem involved in trying to measure average inflation for the economy through an index that includes mortgage interest rates is highlighted by the fact that homeownership costs and mortgage interest rates are subject to any number of influences which makes them much more volatile than the average rate of inflation implied by the trend behavior of unit labor costs. Much of the volatility in real estate markets reflects corresponding volatility in monetary policies. Due to consistently loose monetary policies in 1976-79, credit for homeownership was readily available. Simultaneously, the expectation of continuous inflation led large numbers of people to hold their wealth in the form of physical property rather than financial assets. As a result, there was a wave of speculative buying in real estate during the late 1970s, much of it motivated by an attempt to take advantage of tax deductions and rapidly appreciating home equity values. Conversely, since the start of the New Fed Policy in 1979, the housing cycle has been reversed. As unprecedented interest rates drove the cost of homeownership beyond the capacity of middle income groups to afford it, the drop in real aggregate housing demand caused a virtual collapse in residential construction. In essence, after an inflationary boom in the late 1970s, real estate was now in a deflationary situation. Not only did real output of new homes fall dramatically, the market value of resold homes frequently fell below the book value.

Nevertheless, the CPI gives a totally misleading picture of these developments. Instead of picking up the deflationary trend in the housing market, the CPI accelerated in 1979-80 due to the rise in nominal mortgage interest rates.

Comparisons Between the CPI and Other Indexes. A comparison of the CPI and the more widely-based GNP Deflator underlines the inadequacy of the CPI as a measure of inflation rates in general. As Table 1 indicates (see Appendix), throughout the postwar period, the CPI and the GNP Deflator have frequently exhibited substantial divergence.

In 1946-47, the GNP Deflator rose much more rapidly than the CPI during the inflationary explosion in the immediate aftermath of the Second World War, due to the release of wage-price controls and massive shortages of raw materials on global commodity markets. On the other hand, as the effects of the decontrol shock were absorbed into the price level, the GNP Deflator began to decelerate in 1947 at a time when the impact of prior price movements at the wholesale level were causing consumer prices to accelerate. The Korean War inflation, which was triggered by a wave of speculative buying, was clearly more acute as measured by the CPI than by the GNP Deflator. During the low inflation period of the 1950s, the CPI seems to have understated the rate of inflation, mainly because cost increases were more pervasive in primary products, which are measured in the GNP Deflator but not in the CPI. Throughout the 1960s, there is little significant divergence between the two indexes. However, as the figures for 1971-73 indicate, the Nixon Administration's wage-price controls deflected consumer prices downward to a greater degree than the inflation rate for the entire economy. Similarly, when the controls were removed in 1974, the decontrol rebound was also more pronounced at the consumer level. Although the CPI was less than one percentage point ahead of the GNP Deflator in 1976-78, in 1979-81 the effects of the distortions in the CPI became particularly visible. In 1979, the CPI was rising 11.3% by comparison with 8.5% for the GNP Deflator, while for 1980 the corresponding figures are 13.5% and 9%. Clearly, as an indicator of the inflation rate, the CPI became increasingly inaccurate during the late 1970s. Moreover, much of this problem has had to do solely with the home mortgage cost component.

There is also evidence of wide disparities between the CPI and alternative measures of inflation at the consumer level. For instance, the rate of increase in the cost of living as measured by the Personal Consumption Expenditures (PCE) Deflator was 8.9% in 1979, 10.2% in 1980 and 8.3% in 1981. Comparing these figures to those reported in Table 1 reveals that the inflation rate at the consumer level as measured by the PCE Deflator is much closer to the inflation rate for the entire economy as measured by the GNP Deflator than it is to the CPI.

There are, of course, problems with both alternative measures of inflation, and these comparisons should not be taken to imply that the GNP and PCE Deflators are necessarily accurate measures of the inflation rate. However, the fact that the majority of alternative indexes (including a CPI where housing costs are based on a rental equivalency measure) show inflation rates that are lower than those reported by the CPI in 1979-81 corroborates the view that the CPI has tended to overstate the inflation rate.

POLICY IMPLICATIONS OF THE CPI

The overstatement of the inflation rate by the CPI has had a number of adverse implications for public policy.

1. Since cost-of-living adjustments (COLAs) in collective bargaining in the private sector have on occasion involved indexation of wages to the CPI, in these instances the result has been to raise unit labor costs both above free market levels and above the levels commensurate with more realistic cost-of-living adjustments.

Since wage-price guidelines were in force in 1979-80, and there is evidence of widespread compliance with the price standards, the implication of indexation of cost of living adjustments of private sector wages to the CPI is that wages were increased in relation to prices, contributing to the shrinkage of profit margins that took place at this time.

2. The exaggeration of the inflation rate by the CPI probably contributed to the policy mistakes that caused the 1980 recession. In October 1979, one of the main objectives of the New Fed Policy was to achieve a deceleration in the inflation rate. Nevertheless, during the first three months of 1980, the CPI accelerated to over 17%. The apparent inability of tighter money to halt the surge in inflation led to the imposition of credit controls in the second quarter of 1980, which caused real output to fall at an annual rate of 9.9%, the steepest quarterly rate of decline since 1946. In retrospect, however, the credit controls program emerges as a major policy error, which was all the more egregious since it was completely unnecessary. Using the GNP Deflator as a measure, the inflation rate in the first quarter of 1980 was 9.3%, not the 17% range reported by the CPI. In short, the acceleration of the CPI in early 1980 appears to have been due solely to "one-time-only" factors -- the decontrol of domestic oil prices, and the distortion of the housing component of the CPI by high interest rates. Neither of these would have had any permanent effect on the inflation rate, with the result that the credit controls were implemented to forestall

a danger that was more illusory than real. Moreover, since by the second quarter of 1980 the effects of the oil price rebound had largely been absorbed into the price level, the controls did not succeed in reducing the inflation rate below the level it would otherwise have attained, although they made the economic contraction more severe than would have otherwise been the case.

3. The indexation of federal transfer payments to the CPI has placed upward pressure on federal spending, contributing to the "crowding out" of the private sector by the federal government. According to CBO estimates, each percentage point increase in the CPI is associated with about $2 billion in additional spending.

However, it is to be emphasized in this context that the overstatement of inflation by the CPI in and of itself represents only a comparatively small percentage of the total increase in federal spending caused by "uncontrollable" categories such as indexation of transfer payments. To a large degree, the growth in the uncontrollable portions of the budget has been due to indexation in itself, rather than the CPI per se. For this reason, the issues of improved budgetary control and CPI reform should be differentiated. At the present time, the indexation of transfer payments to the CPI has led to an unnecessary politicization of the issue of CPI reform. To the degree that this issue can be separated from the issue of controlling federal outlays, this will facilitate CPI reform, since the issue will be less overtly politicized when the level of transfer payments is no longer directly dependent on the CPI itself.

With respect to the issue of how lags in the computation of cost-of-living adjustments for Federal transfer payments based on the CPI affect the final costs to the government, there is no satisfactory means of resolving this question. Critics of the current system have pointed out that the use of the first quarter to first quarter percent change in the CPI as the basis for indexation will result in a 7.4% increase in benefit payments in July 1982, when the short term inflation rate is in the area of 3% to 4%. However, there is no evidence that going over to another means of indexation based on the CPI (for instance the CPI on a year-over-year or a December to December basis) would save any significant amounts of money. Because of the extreme short term volatility of the CPI itself, there is no way of predicting what implications use of the year to year or December to December indexes would have on future cost of living adjustments. As the following comparison indicates, there have been substantial deviations between the year to year and December to December CPIs:

COMPARISON OF CPI, YEAR TO YEAR AND DECEMBER TO DECEMBER

	1974	1975	1976	1977	1978	1979	1980	1981
1) CPI, Year to Year	11.0	9.1	5.8	6.5	7.7	11.3	13.5	10.4
2) CPI, Dec. to Dec.	12.2	7.0	4.8	6.8	9.0	13.3	12.4	8.9

Source: Department of Commerce, Bureau of Economic Analysis

The CPI on a year over year basis increased more rapidly than the CPI on a December to December basis in 1975, 1976, 1980 and 1981, but less rapidly in 1974, 1977, 1978 and 1979. In short, changing the system of indexation from the CPI on a first quarter to first quarter basis to the CPI on a different basis would not necessarily be preferable from the standpoint of realizing budgetary savings. While some money might be saved in 1982, when the inflation rate is decelerating, it is likely that the reverse would be the case during a period when the inflation rate is accelerating.

In short, for this reason as well as other reasons, NAM continues to believe that modification of the CPI by itself is not a satisfactory means of reducing the cost of federal transfer payments. Although we fully support reform of the CPI, we believe that significant budgetary savings can only be realized if cost of living adjustments are indexed at a lower rate than the inflation rate.

NAM POLICY RECOMMENDATIONS

The National Association of Manufacturers supports the reform of the CPI proposed by the Bureau of Labor Statistics. The transition to a CPI where the housing component is based primarily on a rental equivalency measure will insure that future inflation rates as reported by the CPI will be more realistic. The NAM also supports the gradual phase-in of the new index proposed by the BLS, since this will minimize any distortions caused by an abrupt transition to a new CPI.

The precise effects of the rental-equivalency CPI on reported inflation are difficult to gauge. By 1985, the first year that the new CPI will be fully in use, there should be a massive increase in demand for new housing, due mainly to demographic pressures and a relatively low supply of available units. For this reason, the cost of both rental housing and owner-occupied housing should show considerable increases at this time. Irrespective of the relative magnitudes involved, however, the new CPI will provide a considerably more accurate measure of actual inflationary developments than the one currently in force.

NAM further recommends that, if programs that are currently indexed are to remain so, then the method of indexation should be modified. In testimony before the Task Force on Entitlements, Uncontrollables and Indexing of the House Budget Committee on February 22, 1982, NAM supported modification of indexation of benefit payments by indexing.

> ". . . to a given percentage of a measure of the inflation rate or wages, whichever is less. This percentage should be based on revenue constraints and the rate of increase in other federal programs. In other words, if revenues are reduced, beneficiaries of indexed income transfers should not be compensated more than the corresponding increases in other federal programs. As a working number for the Congress, NAM suggests that the indexation level for FY83 be set at 75%. This can then be re-evaluated in light of changing economic conditions in future years."

NAM would also consider supporting an alternative index apart from the CPI. The rationale for use of the alternative index is twofold. On the one hand, a lower index for cost of living adjustments would mitigate pressure on federal spending since it would realize substantial savings in the number of programs that include COLA provisions. On the other, use of an alternative index would also help depoliticize the issue of CPI reform, since cost of living adjustments would no longer be dependent on the CPI. This, in turn, would facilitate the transition to a more realistic measure of consumer prices.

The NAM further recommends that the issue of indexation be resolved by going over to an alternative index. In earlier testimony to the House Budget Committee, we suggested 75% of the lesser of wages or prices as a possible index for indexation of transfer payments. However, NAM would be willing to support any alternative means of indexation apart from the CPI if this results in substantial budgetary savings. The rationale for use of the alternative index is twofold. On the one hand, reduction of the index used for cost-of-living adjustments to federal programs will mitigate pressure on federal spending. On the other, use of an alternative index will help to depoliticize the issue of CPI reform, since cost of living adjustments will no longer be as dependent on the CPI; this will facilitate the transition to a more realistic measure of consumer prices.

APPENDIX

TABLE ONE: ALTERNATIVE MEASURES OF THE INFLATION RATE, 1946-1981

	CPI	GNP Deflator		CPI	GNP Deflator		CPI	GNP Deflator
1946	8.5	15.7	1959	0.8	2.4	1972	3.3	4.2
1947	14.3	12.9	1960	1.6	1.6	1973	6.2	5.7
1948	7.8	6.9	1961	1.0	0.9	1974	11.0	8.7
1949	-1.0	-0.9	1962	1.1	1.8	1975	9.1	9.3
1950	1.0	2.1	1963	1.2	1.5	1976	5.8	5.2
1951	7.9	6.6	1964	1.3	1.5	1977	6.5	5.8
1952	2.2	1.4	1965	1.7	2.2	1978	7.7	7.3
1953	0.8	1.6	1966	2.9	3.2	1979	11.3	8.5
1954	0.5	1.2	1967	2.9	3.0	1980	13.5	9.0
1955	-0.4	2.2	1968	4.2	4.4	1981	10.4	9.1
1956	1.5	3.2	1969	5.4	5.1			
1957	3.6	3.4	1970	5.9	5.4			
1958	2.7	1.7	1971	4.3	5.0			

Source: Department of Commerce, Bureau of Economic Analysis

Senator MATTINGLY. Our next witness will be the director of economic surveys from the Gallup Organization, Mr. Jay Schmiedeskamp, who has done a fascinating study on social security and COLA's that we first heard about from Dr. Clifton from the U.S. Chamber of Commerce during our hearings on April 20. I would like to welcome the director, Mr. Schmiedeskamp.

If you would like to begin. It is a very interesting statement that you have to present.

TESTIMONY OF JAY SCHMIEDESKAMP, DIRECTOR OF ECONOMIC SURVEYS, THE GALLUP ORGANIZATION

Mr. SCHMIEDESKAMP. Thank you, Mr. Chairman.

Senator, it is a pleasure to be here today. My main purpose in being here is to ensure that a recent survey conducted by the Gallup Organization for the U.S. Chamber of Commerce is properly understood and interpreted.

The survey, which measured consumer attitudes toward social security and cost-of-living adjustments, was conducted with a nationwide probability sample of the U.S. public, 18 years and older, during the period March 22–April 3, 1982. Telephone interviews were completed with 1,028 respondents.

Gallup's national telephone sample is derived from the national probability sample used in Gallup's ongoing national personal interview surveys, which have a long-established record for reliability. I won't bore you with the details set forth in my printed statement, but the net effect is careful stratification of the respondents by region, city size, and rural versus urban areas.

In interpreting the survey results, it is very important to understand the structure of the questionnaire, a copy of which is appended to my statement. Respondents were asked several questions before they were given the information that social security payments have increased a total of 40 percent in the last 3 years because of automatic increases tied to the Consumer Price Index.

The first question found a majority of all respondents, 57 percent, with the opinion that the social security payments retired people are receiving are lower than they should be. Interestingly, this opinion is more widely held among currently employed respondents, 61 percent, than it is among respondents who are currently retired, 35 percent. Other findings in the survey suggest that this difference is in large part due to the fact that retired people are better informed than are currently employed people with respect to the CPI COLA.

Before being informed about the CPI COLA, respondents were asked another question which found a majority of all respondents, 57 percent, believing that in the last couple of years the social security income that people receive has gone up by less than the CPI. This false impression is held by 60 percent of employed people and even among retired people by 41 percent.

After respondents had been told that social security payments had increased a total of 40 percent over the last 3 years because of automatic increases tied to the Consumer Price Index, only 38 percent of all respondents said they would have voted for a larger increase. In other words, after being informed about the CPI link, 19 percent of all respondents changed from the view expressed in the earlier question that social security benefits are lower than they should be.

Among those respondents who are currently employed, 23 percent changed their opinion, compared to only 7 percent among the retired people who were better informed on this issue to begin with.

These data demonstrate the importance of a campaign to educate the public to the fact that social security has been indexed by a full COLA.

A large majority of the public is correctly aware that the social security system is in financial trouble. Fully 80 percent think that there are major financial problems that have to be dealt with, although only 11 percent believe that the system will have trouble meeting its financial obligations within 1 year if no changes are made. This proportion rises to 30 percent expecting trouble within 3 years and 52 percent expecting problems within 5 years.

Only half of all respondents are aware that the system now pays out more money than it receives. But fully 63 percent of currently employed respondents are afraid that they might not receive social security payments at all. To be sure, our question posed this to respondents as one of three possible outcomes, which no doubt led some respondents to give this answer who otherwise would not have done so. But nevertheless, these data suggest a strong element of public concern about the extent to which social security payments can be relied on.

While many people know the system has financial problems, relatively few have an opinion about why the system is in trouble. Our question posed three possible reasons to respondents. Only 9 percent of all respondents said that the main cause of the problem is that "taxes are too low," which is not a surprising outcome in light of numerous surveys which evidence the widespread view that taxes are too high. Only 11 percent said that "benefits are too high," which is not surprising in view of the widespread preconception that benefits are too low, as seen in the answer to the first question in our survey.

Twenty-seven percent of respondents attributed the trouble to benefits being "adjusted upward too much for inflation," even after being informed of the 40-percent COLA adjustment in the last 3 years. It must be remembered in this connection that a majority felt, prior to being informed, that benefits had gone up by less than the CPI.

One-third of all respondents simply answered that they didn't know what was the main cause of the financial problem in the social security system.

Among respondents who believe that the system has major financial problems, which is 80 percent of all respondents, opinion is closely divided on which party is playing the more "responsible role trying to get social security back onto a more sound financial footing."

Finally, a number of questions in the survey specifically addressed the issue of cost-of-living adjustments for social security. All of these questions, it must be remembered, came in the questionnaire after respondents had been informed of the 40-percent COLA rise in social security benefits over the last 3 years.

One question asked whether a Senator or Congressman voting to freeze benefits "temporarily at their existing level for 1 year rather than having them rise automatically with the Consumer Price Index" would make the respondent more likely or less likely to vote for that Senator or Congressman. In reply, fully 33 percent of all respondents chose a third alternative posed in the question; namely, that this would not be an important issue. Another 26 percent said this would make them more likely to vote for the Senator or Congressman, making a solid majority of 59 percent saying either "more likely" or "not an important issue." One-third of all respondents said a vote for a temporary freeze would make them less likely to vote for the Senator or Congressman.

This question was worded clearly to mean social security benefits temporarily not going up rather than checks going down or fewer people receiving the checks. The importance of wording the question this way is demonstrated by the results of a different, previous question which show that for a majority of respondents, budget cuts in social security imply a reduction either in the number of people receiving checks or in the dollar amount of checks, for a total of 51 percent believing those things.

In other words, the reaction to a vote by a Senator or Congressman is dependent in part on how the budget reduction is perceived by voters—as a reduction or as a reduced or eliminated increase in benefits.

In yet another question respondents were told that in 1983 automatic COLA's for Federal programs will cost the Government about $21 billion and also told, what many people already know, that Government is reducing its spending in many areas. With this information, public opinion is rather evenly divided about whether COLA's "should be reduced in the same proportion as other spending" or should not be reduced.

The public is also rather evenly divided about whether COLA's should be fully and automatically applied to social security benefit payments and to Federal pension payments for Government employees and the military or whether any increases should be left up to Congress each year. An overwhelming majority of those believing that COLA's should be automatically applied said that the increase should be less than or equal to the average COLA in private industry.

In sum, these data suggest that for many people a temporary freeze or other adjustment to the full CPI social security COLA would not be an important issue. But this is true only if the public is educated to the fact that social security has been adjusted by the full CPI and that no one will have the dollar amount of their check reduced or their check taken away. Thank you.

Senator MATTINGLY. Thank you.

First of all, let me say that I am glad you are here to underscore the findings of that survey which you performed for the chamber of commerce. I think that these proper findings have proved people who are going to be affected by any sort of change to the CPI realize this change is not going to affect their benefits. The other people who do not understand it are the ones who are not actually impacted by any proposed changes.

On April 20 we had both labor and management people who came in for the hearings who testified on this use of the CPI. Since most workers do not have these automatic adjustments for their wages, do you feel that the Federal programs that are indexed are better protected from inflation than most Americans?

Mr. SCHMIEDESKAMP. That certainly has been the case in recent years when the CPI has overstated inflation. As I think some of the previous witnesses here have testified, what is really lacking is some kind of a CPI measure for elderly people. I mean, one obvious point there is that relatively few elderly people pay interest, for several reasons. By the time most people retire, they have their debt wrestled to the ground. Second, they are not inclined to incur new debt. In any event, a very small part of the elderly person's budget goes for interest rates. Yet, a full 11.8 percent of the CPI is interest rates.

One of the interesting facts is that in inflation, it seems to be the conventional wisdom of economists, with which I do not agree, by the way, that the proper way to fight inflation is with higher interest rates. Interest rates then feed into the total CPI. And with so many COLA's tied to the CPI, and in the case of the Government a full CPI, that then completes the circle and feeds the problem of inflation.

My own personal feeling is that fighting inflation with a high interest rate is a little bit like pouring gasoline on a fire. But the full CPI COLA and the flaws in the CPI make that high octane gasoline.

Senator MATTINGLY. That is true.

One comment you made in your statement was that an overwhelming majority of those people believe that the COLA's should be automatically applied and the increase should be less than or equal to the average COLA in private industry.

I believe, if I remember correctly, when the AFL-CIO came before us, they made the comment they were only being reimbursed for roughly 60 percent of the CPI, if I am not mistaken, which goes I think to support what you are saying. If in fact that is the case, even for the small number who are indexed in the private sector, than those that are impacted by COLA wouldn't be upset over being equated to the private sector; is that correct, that interpretation?

Mr. SCHMIEDESKAMP. That is correct. The one flaw that bothers me in the survey, the one mistake I know of that I made is I wish I had asked that question of all people, not just those who felt that they would prefer an automatic COLA adjustment rather than leaving it up to Congress. But that is the only qualification with what you said. In other words, of those who prefer the automatic increase, the equity issue is perceived as being an important issue. Interestingly enough, even the retired people feel that way.

Senator MATTINGLY. That is what I saw in a survey, that really, when you get the figures, 83 percent of them who understood what we were talking about in Washington knew they weren't going to get less. Only 17 percent thought they were going to get less via

COLA adjustments, and with the political dialog going on, that was rather impressive.

As a professional pollster, do you feel that the data that is 10 or 12 years old are correct for determining current consumption patterns such as now done in the CPI?

Mr. SCHMIEDESKAMP. I don't know. My own personal feeling is that given the amounts of money that ride on these things, that the Government could and should do a better job than they do of updating these statistics. Not only that, but certainly if it would not be an enormous expenditure on the Government's part to provide a separate index for retired people. In other words, the added cost of doing that is in my judgment nearly negligible, given the vast number of price indexes that the Government already puts out. As far as I know, no concerted effort has been made to do that.

Senator MATTINGLY. As a professional pollster, couldn't you put together a survey that would be simple and yet accurately reflect the cost of living faced by the average American that could be performed fairly frequently?

Mr. SCHMIEDESKAMP. Performing a service like that to our Nation would far exceed the resources of the Gallup organization. However, it would not exceed the resources of our Government or even come close to it, in my opinion.

I think one of the problems is that it is seen as being a vastly more complicated procedure than it is and therefore is undertaken only very infrequently and with a great deal of gnashing of teeth and delay. In my opinion it would be much more important to do it frequently and get on with it. However, there have been earlier comments in this hearing about the wheels of government grinding slowly. That is just yet one more example.

Senator MATTINGLY. Right, which gets me to the other question. The one problem I have been interested in, and also want your opinion on as a professional, is this long-range timing of the CPI which we have, a 15-month, five-quarter figure that we operate with. Do you feel it is reasonable to have a stale figure of the old CPI affecting the large amounts of money Congress has it involved in?

Mr. SCHMIEDESKAMP. No, Senator. I would fully agree with your analysis of it. I would hate to see it based on one quarter simply because I feel there is a great deal of volatility in one quarter. But having it based on five quarters and then yet another quarter delay before it is put into effect is a bit much and does no doubt demonstrably generate inequities.

Senator MATTINGLY. You hit the nail right on the head. I intend to help change that. I appreciate the information you have brought to us.

Mr. SCHMIEDESKAMP. Good luck.

Senator MATTINGLY. I thank you for coming to testify.

Mr. SCHMIEDESKAMP. My pleasure.

[The questionnaire and survey responses submitted by Mr. Schmiedeskamp follow:]

QUESTIONNAIRE & SURVEY RESPONSES

SURVEY RESPONSES
(Percent of Responses)
N= 1,028

1. Thinking about the amount of social security benefits the government pays to retired people, and taking into consideration everything else the government spends money on -- do you think the social security payments retired people are receiving are higher than they should be, lower than they should be, or are just about the right amount?

	STATUS		
	Total	Employed	Retired
Higher than should be	9%	8%	6%
Lower than should be	57	61	35
Just about right amount	30	26	55
Don't know	4	5	4

2. Are you retired now, or are you currently employed, a student, housewife, or what?

		Total	Employed	Retired
Retired now -- CONTINUE WITH Q. 4		17%	N/A	N/A
Currently employed	GO TO Q. 3	57		
Student, housewife		19		
Unemployed, laid off		5		
Other (specify)		1		
Don't know		1		

3. What do you expect when you retire -- will the social security benefits you receive be better than those received by retired people today, or not as good, or are you afraid you might not receive social security payments at all?

	Total	Employed	Retired
Will be better	7%	7%	N/A
Not as good	14	16	
Will not receive at all	52	63	
Will be same as those today (VOLUNTEERED)	7	9	
Don't know	4	5	
No response	16	N/A	

	STATUS		
	Total	Employed	Retired
4. In the last couple years, do you think the social security income that people receive has gone up by more than the consumer price index, less than the consumer price index, or about the same amount?			
More than consumer price index	6%	7%	5%
Less than consumer price index	57	60	41
About the same amount	28	27	40
Don't know	9	6	14
5. Do you believe that living costs for retired people go up faster than living costs for working families, go up more slowly, or go up at about the same rate?			
Go up faster	17%	18%	13%
Go up more slowly	24	26	18
Go up at same rate	56	52	62
Don't know	3	4	7
6. Over the last 3 years, social security payments have increased a total of 40 percent because of automatic increases tied to the consumer price index. If you were a member of Congress voting on this issue, would you have voted to increase social security payments by 40 percent during the last 3 years, or would you have voted for larger, or for smaller increases?			
40 percent increase	33%	31%	46%
Larger increase	38	38	28
Smaller increase	20	24	11
Don't know	9	7	15
7. As you probably know, the Social Security System gets its money from payroll taxes paid by employers and people during their working years, and pays out money to people when they are retired. Do you happen to know, is social security at present paying out more money than it is receiving, paying out less money than it is receiving, or paying out about the same amount as it is receiving?			
Pays out more money than receives	50%	55%	46%
Pays out less money than receives	17	16	11
Pays out same as receives	14	12	16
Don't know	19	17	27

8. From what you have heard or read, do you think the Social Security System has major financial problems that have to be dealt with, or is it in essentially sound financial condition if things are continued as they are?

		STATUS		
		Total	Employed	Retired
Financial problems		80%	86%	62%
Essentially sound	GO TO Q. 9	13	9	25
Don't know		7	5	13

IF PROBLEMS, ASK Q. 8a, 8b, AND 8c

8a. If no changes are made in the Social Security System, how soon do you think the system might have trouble meeting its financial obligations -- within one year, three years, five years, ten years, or longer than that?

	Total	Employed	Retired
Within one year	11%	11%	11%
Three years	19	21	16
Five years	22	24	11
Ten years	13	16	5
Longer than that	7	7	4
Don't know	8	7	15

8b. What do you believe is the main cause of the financial problem in the Social Security System -- is it because social security taxes are too low, or because social security pays benefits that are too high, or because the benefits have been adjusted upward too much for inflation in recent years?

	Total	Employed	Retired
Taxes are too low	9%	10%	6%
Benefits are too high	11	10	13
Adjusted upward too much for inflation	27	31	10
Don't know	33	36	33

8c. Which political party do you think is playing the more responsible role in trying to get social security back onto a more sound financial footing -- Republicans, Democrats, or are the two parties about equal in this respect?

	Total	Employed	Retired
Republicans	19%	22%	16%
Democrats	22	22	19
Two about equal	30	33	17
Don't know	9	9	10

9. If a Presidential Commission were set up to advise the President on the most appropriate actions to take with respect to the Social Security System, would you favor a commission made up mostly of older citizens at or near retirement age, or one that has half older citizens and half younger citizens?

	STATUS		
	Total	Employed	Retired
Mostly older citizens	17%	14%	28%
Half older, half younger	80	84	66
Don't know	3	2	6

10. In your opinion, should the President be given authority to reduce social security payments by the proportion that other government spending programs have to be reduced when there is a large deficit in the government budget, or should the President not be given authority to do that?

	STATUS		
	Total	Employed	Retired
Should be given authority	20%	21%	11%
Should not be given authority	76	77	81
Don't know	4	2	8

11. Some people have proposed that there should be budget cuts in the total amount that the Social Security System is scheduled to pay out to retired people this year. From what you nave heard, do you think this would result in reducing the number of people who receive checks, reducing the dollar amount of the checks people receive, or would the dollar amount of the checks stay the same as before instead of going up?

	STATUS		
	Total	Employed	Retired
Reduce number of people who receive checks	17%	17%	15%
Reduce dollar amount of the checks	34	40	17
Dollar amount stay the same (instead of going up)	33	30	38
Don't know	16	13	30

12. If your Senator or Congressman voted to freeze social security benefits temporarily at their existing level for one year rather than having them rise automatically with the Consumer Price Index, would this make you more likely to vote for that Senator or Congressman, or less likely, or would this not be an important issue for you in deciding how you would vote?

	STATUS		
	Total	Employed	Retired
More likely	26%	28%	28%
Less likely	34	33	33
Not important issue	33	33	33
Don't know	7	6	6

13. Some types of income payments are automatically increased by the same proportion as increases in the Consumer Price Index. Do you believe that these cost-of-living adjustments should automatically be applied to social security benefit payments and to federal pension payments for government employees and the military, or should any increases be left up to Congress each year?

		STATUS		
		Total	Employed	Retired
Should automatically be applied		44%	42%	44%
Should be left up to Congress	GO TO Q. 14	45	48	38
Don't know		11	10	18

13a. Should these automatic federal government cost-of-living adjustments be greater than, less than, or equal to the average cost-of-living adjustments in labor contracts negotiated with private industry?

	Total	Employed	Retired
Greater than	3%	3%	3%
Less than	5	6	4
Equal to	32	30	30
Don't know	4	3	7
Do not believe COLA should be automatically applied	56	58	56

14. In 1983, automatic cost-of-living adjustments for federal programs will cost the government about 21 billion dollars. At present, government is reducing its spending in many areas. Do you think cost-of-living adjustments should be reduced in the same proportion as other spending, or should cost-of-living adjustments not be reduced?

	Total	Employed	Retired
Reduced in same proportion as other spending	48%	49%	46%
Not be reduced	44	43	42
Don't know	8	8	12

15. The President's budget as submitted to Congress earlier this year calls for spending cuts in many small programs, but two of the largest items -- social security and defense -- were not reduced. If both social security and defense were scaled back by the same proportion as all other items in the budget, would this make you more favorable or less favorable toward the President's budget?

	Total	Employed	Retired
More favorable	35%	37%	28%
Less favorable	49	48	51
Would make no difference (VOLUNTEERED)	7	6	8
Don't know	9	9	13

Senator **Mattingly**. That concludes the hearing for today. Thank you all very much.

[Whereupon, at 11:05 a.m., the subcommittee was recessed, to reconvene subject to the call of the Chair.]

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

ALAN S. BLINDER
Princeton University and
National Bureau of Economic Research

The Consumer Price Index and the Measurement of Recent Inflation

THE consumer price index in the United States may be the most closely watched economic barometer in the world. Yet in recent years, as the public and the media have paid increasing attention to the monthly CPI announcements, more and more economists and officials have expressed dissatisfaction with the way the CPI measures inflation. The construction of price indexes, once an arcane subject used to torture graduate students, is now a subject debated in the halls of Congress and discussed on the nightly television news. In the wake of the stunning recent gyrations in the CPI inflation rate, this seems an opportune time to reexamine the index—and especially its treatment of housing, which has been so much in the public eye of late.

The first three rows of table 1 give a hint both that something is amiss, and that the problem is of recent vintage. The all-items CPI and the implicit deflator for personal consumption expenditures (hereafter PCE deflator) differ in numerous ways. The PCE deflator counts only currently produced consumer goods and services, and—at least in principle—includes them all; the CPI is based on a selected list of about 250 items, including several important used items (used cars, resold houses). The PCE deflator uses current-period weights (a Paasche index), while the

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I thank Henry J. Aaron, Stephen M. Goldfeld, Daniel Hamermesh, Walter F. Lane, Frank de Leeuw, Jack E. Triplett, and members of the Brookings panel for helpful conversations and Danny Quah for research assistance. Research support from the National Science Foundation is gratefully acknowledged.

0007-2303/80/0002-0539$01.00/0 © Brookings Institution

Table 1. Alternative Measures of Annual Rates of Inflation, Selected Periods, 1947–80
Percent per year

	Period[a]				
Item[b]	*1947–77*	*1977*	*1978*	*1979*	*1980, first half*
All-items CPI	3.38	6.6	9.0	12.7	15.9
PCE Deflator	3.32	5.6	7.4	9.9	11.6
CPI minus PCE deflator	0.06	1.0	1.6	2.8	4.3
CPI without mortgage interest cost	...	6.5	8.2	11.2	12.8
Fixed-weight PCE deflator	...	5.9	7.9	10.7	12.4
CPI without mortgage-interest cost minus fixed-weight PCE deflator	...	0.6	0.3	0.5	0.4

Sources: Data for the fixed-weight and implicit PCE deflator are from *Survey of Current Business*, vol. 60 (September 1980), tables 20 and 26, pp. 16–17, respectively, and preceding issues. The CPI data are from the U.S. Department of Labor, Bureau of Labor Statistics.

a. For the 1947–77 period, year average to year average; for 1977–79, fourth quarter to fourth quarter; and for the first half of 1980, 1979:4 to 1980:2 at annual rates.

b. Seasonally adjusted data, except for the all-items CPI.

CPI uses base-period weights (a Laspeyres index). The PCE deflator covers the entire population, while the CPI is for only urban (about 80 percent of the population).[1] The list of differences could go on, as could a recitation of the multifaceted "index number problem."

But despite all this, the two indexes have on average given very similar measures of inflation over a long historical period. The first column of the table shows that over a thirty-year period ending in 1977 the compound annual inflation rates implied by the two indexes are less than 0.1 percentage point apart. This is perhaps not surprising because most of the components of the PCE deflator are price series from the Bureau of Labor Statistics. However, the close correspondence has vanished in recent years. In 1977 the CPI registered 1 point more inflation than the PCE deflator. In 1978 the gap was about 1½ points, with the CPI high again. The problem really became acute during 1979, when the CPI rate of inflation exceeded the PCE rate of inflation by almost 3 points, and during the first half of 1980, when the gap was about 4 points. These numbers suggest that there may be problems with the CPI.

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[1] The reference here, and elsewhere in the paper, is to the CPI for all urban consumers (CPI-U). The CPI-W covers only urban wage earners and clerical workers, about 45 percent of the population.

This paper focuses on two of these problems: the CPI's use of fixed weights in a period when large relative price changes are leading to substantial adjustments in spending patterns and its treatment of homeownership (and especially mortgage interest) costs. The last three rows of table 1 show that these two features of the CPI explain many of the discrepancies between the two indexes. The fourth row adjusts the CPI by removing mortgage interest costs; because 1977–80 was a period of rising interest rates, this adjustment results in less inflation each year. The fifth row reports the rates of change of the Bureau of Economic Analysis's fixed-weight version of the PCE deflator; as index number theory leads one to expect, the growth rate of this fixed-weight deflator always exceeds that of the standard PCE deflator (see below). By comparison with the numbers in the first three rows, the differences between the two indexes presented in the last three rows are quite small indeed—almost always less than half a percentage point.

The Weighting Issue

Any overall price index is a weighted average of its constituent parts. There are three basic decisions to be made: what items to include, how much weight to assign to each item; and whether to use fixed (base-period) weights or variable (current-period) weights. The first two decisions constitute the choice of the so-called market basket; the third is the choice between a Laspeyres and a Paasche index.

Except for the issue of how much weight to place on homeownership, which I take up in the following section, I have little to say about the market basket. Although it would be conceptually superior to include all consumer goods and services (instead of 80 percent), the CPI's market basket is probably broad enough and sufficiently well selected (based on two comprehensive expenditure surveys in 1972–74) to measure very accurately the increase in income necessary to buy any reasonably representative market basket.[2]

[2] U.S. Department of Labor, Bureau of Labor Statistics, *Consumer Expenditure Survey: Interview Survey, 1972–73,* Bulletin 1997 (U.S. Government Printing Office, 1978) and *Consumer Expenditure Survey: Diary Survey, July 1972–June 1974,* Bulletin 1959 (GPO, 1977).

The real issue is whether to use a fixed market basket or an evolving one. As everyone who has ever been a graduate student of economics knows, a Laspeyres index (such as the CPI) tends to overstate inflation relative to a "true" cost-of-living index while a Paasche index (such as the PCE deflator) tends to understate it. The reason is simple to explain. When different prices rise at different rates, consumers have the opportunity to escape part of the burden of inflation by buying substitutes for the goods whose prices are escalating most rapidly. The Laspeyres index ignores this possibility and therefore exaggerates the utility loss from inflation. The Paasche index assumes, equally incorrectly, that these substitutions entail no loss of satisfaction, and hence understates the burden of inflation.

Since the CPI is a Laspeyres index and the PCE deflator is a Paasche index, we should not be surprised if the former shows higher inflation than the latter. (The comparison is not a clean one, however, because the two market baskets differ.) This has been known for years—and has been thought unimportant. There was probably good reason to think so because the first column of table 1 shows that the CPI rose only trivially faster than the PCE deflator from 1947 to 1977.

A cleaner comparison between Paasche and Laspeyres indexes is obtained by looking at the PCE deflator and a fixed-weight PCE deflator. The compound annual rate of increase of the latter between 1958 (when it began) and 1977 was 3.71 percent while that of the former was 3.80 percent. It is hard to take this difference seriously. But recent performance appears to have departed from this pattern. The rate of increase of the fixed-weight PCE deflator exceeded that of the conventional PCE deflator by 0.3, 0.5, 0.8, and 0.8 percentage point in 1977, 1978, 1979, and the first half of 1980, respectively (see table 1).

These differences, however, reflect more than the pure difference between a Laspeyres and a Paasche index. To understand why, it is necessary to introduce some of the arithmetic of price indexes. Begin with the simplest case, that of a fixed-weight index such as the CPI or the fixed-weight PCE deflator. Such an index is a weighted average of its components. With P_t denoting the overall index and p_{it} the components, the expression is

$$P_t = \sum_i w_{io} p_{it}, \tag{1}$$

where the w_{io} are the base-period expenditure weights:

$$w_{io} = \frac{p_{io} c_{io}}{\sum_i p_{io} c_{io}}, \tag{2}$$

where c_{it} is the quantity of the ith item consumed in the tth period. If the shorthand notation $\dot{P}_t$ and $\dot{p}_{it}$ indicate one-period proportional rates of change, some straightforward computations of (1) yield

$$\dot{P}_t = \sum_i r_{it}\dot{p}_{it}, \tag{3}$$

where r_{it} is called the *relative importance* of item i in period t and is defined by

$$r_{it} = w_{io}\frac{P_{i,t-1}}{P_{t-1}}. \tag{4}$$

The PCE deflator is a current-period-weight index defined by

$$P_t = \frac{\sum p_{it}c_{it}}{\sum p_{io}c_{it}} = \sum w_{it}p_{it}, \tag{5}$$

where

$$w_{it} = \frac{1}{p_{io}}\,\frac{p_{io}c_{it}}{\sum p_{io}c_{it}}, \tag{6}$$

are the (variable) weights.[3] A little algebra shows that the rate of change of the PCE deflator can be written

$$\dot{P}_t = \sum_i \rho_{i,t-1}\dot{p}_{it} + \sum_i \rho_{i,t-1}\frac{p_{it}}{p_{i,t-1}}\,\dot{w}_{it}, \tag{7}$$

where

$$\rho_{it} = \frac{p_{it}c_{it}}{\sum p_{it}c_{it}} = \frac{p_{it}}{P_t}\,w_{it} \tag{8}$$

are the period t expenditure weights and $\dot{w}_{it}$ is defined as the percentage rate of change of w_{it}. Comparing equation 7 with 3 reveals two major differences. First, equation 7 contains a second sum that does not appear in 3. This is called (for obvious reasons) the "contribution of shifting weights," and if it is removed from the index one obtains the rate of change of what is called the PCE chain index. The chain index is basically a one-period Laspeyres index, which takes as its relative importances for period t the expenditure weights of period $t-1$ and updates these weights each period. That these relative importances differ from those used in 3 is the second source of difference between the PCE deflator and the CPI.[4]

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[3] By convention, all p_{io} are set to unity, so w_{it} is the weight in *real* expenditure.

[4] In the case of constant weights, the $\rho_{i,t-1}$ in equation 7 and the r_{it} in 3 are equal. (This follows from equations 8 and 4.)

Table 2. Alternative Measures of Inflation, 1977 through First Half of 1980
Percent per year

	Period[a]			
Item[b]	*1977*	*1978*	*1979*	*1980, first half*
PCE deflator	5.6	7.4	9.9	11.6
PCE chain index[c]	6.0	7.8	10.3	11.9
Fixed-weight PCE deflator	5.9	7.9	10.7	12.4
Fixed-weight PCE deflator minus PCE deflator	0.3	0.5	0.8	0.8
Fixed-weight PCE deflator minus PCE chain index	−0.1	0.1	0.4	0.5

Source: *Survey of Current Business*, vol. 60 (August 1980), tables 20, 26, and 27, pp. 13–15, and preceding issues.

a. Seasonally adjusted data. For 1977 through 1979, fourth quarter to fourth quarter; for the first half of 1980, 1979:4 to 1980:2 at annual rates.

b. The PCE deflator corresponds to equation 7; the PCE chain index, to the first term of equation 7; and the fixed-weight PCE deflator, to equation 3.

c. Defined only as a one-period change. The numbers shown are the cumulative change implied by the one-quarter changes over the intervals shown.

Thus to isolate the pure effect of commodity substitution, that is, of changing weights, one must look at the difference between the rates of change of the fixed-weight PCE deflator (equation 3) and the PCE chain index (the first sum in equation 7).

Recent rates of change of all three versions of the PCE deflator are shown in table 2. It is clear from these numbers that only about half the recent discrepancies between the conventional and fixed-weight PCE deflators can be traced to commodity substitution. The remainder reflects changes in purchasing patterns stemming from other sources. (Compare the last two columns.) It is notable nonetheless that a good deal of the difference between the CPI and the PCE deflator is accounted for by the weights on food and gasoline—commodities whose relative prices were changing rapidly—as can be seen in the components of the second row in table 3. This table is an aggregated, and drastically reorganized, version of the BEA's quarterly reconciliation of the two indexes. The first and last two rows indicate the gap that needs to be explained; the remaining items provide the explanation.

Look again at the second row in table 3, which shows the portion of each year's discrepancy that can be explained by differences in weighting. During 1978, of the 1.33 percentage points difference between the two inflation rates, differences in weighting schemes accounted for 0.63 percentage point, about half the total. Food was the major item. Between 1977:4 and 1978:4 there was essentially no growth of real expenditures on food. As a result, the proportion of real consumer spending devoted to food fell from 0.19 to 0.18—a large change in weight in just a single year.

In 1979 differences in weighting again accounted for roughly one-half of the discrepancy between the CPI and PCE rates of inflation: 1.43 percentage points out of a total of 2.90. This time energy held center stage. Indeed, the story is even more specific than that—it focuses almost entirely on gasoline. Although gasoline rose in price by 51 percent, absolute spending on gasoline in 1972 dollars dropped 11 percent. Consequently, the weight of gasoline in total real consumption fell from 3.2 percent to 2.8 percent. Of the 1.43 percentage points attributable to differences in weighting, gasoline alone accounted for 1.40 percentage points. Much the same story was repeated in the first half of 1980. Although different weights accounted for less than one-third of the discrepancy between the two measures of inflation—1.10 points out of 3.75 points—gasoline weights alone were sufficient to account for 1.65 points.

In brief, the period from 1978 on has been one of those rare times in which substantial differences between a Laspeyres index and a Paasche index are expected to arise. Measuring the recent inflation with a Laspeyres index (such as the CPI) is bound to give a more pessimistic view of what has happened than one could obtain with a Paasche index (such as the PCE deflator) because consumers have found substitutes for the items that have inflated most rapidly—food and energy.

Before leaving the weighting issue, one further aspect of the arithmetic of price indexes is important enough to be noted here. The inflation rate recorded by any price index is a weighted average of the inflation rates of its individual components. Unless the index is a geometric weighted average—and none of the officially published indexes are—these weights will *not* be constant over time, even in a Laspeyres index such as the CPI. It is easy to see why this is so. The rate of change of the CPI is given by a formula like equation 3. From equation 4 it is clear that items whose relative prices are rising are automatically given increasing relative importance in the overall index even if their weights w_{it} are constant over time. This arithmetic has assumed some significance in recent years as rising energy prices have induced consumers to substitute away from

Table 3. Comparison of the CPI and the Personal Consumption Expenditures Deflator, 1978 through the First Half of 1980[a]

	Period					
	1978		*1979*		*1980, first half*[b]	
Item[b]	*Percent*	*Percentage points*	*Percent*	*Percentage points*	*Percent*	*Percentage points*
Rate of change of CPI	8.93		12.75		15.30	
Minus: Differences in weighting schemes		0.63		1.43		1.10
Contributions of shifting weights		0.33		0.58		0.35
Gasoline		−0.20		0.60		0.55
Food		0.83		−0.10		−0.75
Other (residual)		−0.30		0.08		0.50
Contributions of differences in weights		0.30		0.85		0.75
Gasoline		0.08		0.80		1.10
Food		0.40		0.43		0.25
Other (residual)		−0.18		−0.38		−0.65
Minus: Differences in coverage		0.67		1.20		2.50
Treatment of homeownership		1.13		1.83		3.45
All other (residual)		−0.46		−0.63		−0.95
Minus: Differences in seasonal adjustment		0.03		0.03		−0.10
Equals: Rate of change of PCE deflator	7.60		9.85		11.55	
Rate of change of CPI minus rate of change of PCE deflator		1.33		2.90		3.75

Source: Computed by the author from data of the U.S. Department of Commerce, Bureau of Economic Analysis. The underlying quarterly data for 1978:2–1980:2 are unpublished revisions provided by James Byrnes of the BEA. Data for 1978:1 are from *Survey of Current Business*, vol. 58 (May 1978), table 3, p. 3, and are based on the unrevised version of CPI-W.

a. The CPI data in the first row differ from those in tables 1 and 2 because of seasonal factors and subsequent data revisions. Components do not add to totals due to rounding.

b. Seasonally adjusted data at annual rates.

Table 4. Homeownership Costs and Overall Inflation, 1977 to First Half of 1980
Annual rate of inflation, in percent

	Period			
Item	*December 1976–December 1977*	*December 1977–December 1978*	*December 1978–December 1979*	*December 1979–June 1980*[a]
Homeownership costs	9.2	12.4	19.8	24.7
All-items CPI	6.8	9.0	13.3	16.0
All-items CPI minus homeownership costs	6.1	8.0	11.3	13.2

Sources: Bureau of Labor Statistics, *CPI Detailed Report, June 1980* (U.S. Government Printing Office, 1980), table 1, pp. 9–11, and similar preceding reports.

[a] Not seasonally adjusted data at annual rates.

energy. For example, between 1976:4 and 1979:4 the share of energy in total nominal consumption rose only from 8.4 to 9.1 percent as consumers reacted to higher prices by buying less (the share in total real consumption fell from 6.7 to 5.8 percent). Despite this, the relative importance of energy in the CPI rose from 0.074 in December 1976 to 0.103 in December 1979. Thus any given percentage increase in energy prices contributes about 40 percent more to the overall inflation rate today than it would have in 1977 even though consumers are spending only a slightly greater fraction of their current budgets on energy today. It is simply an arithmetic conclusion that the relative importances used to determine the average inflation rate must differ from the weights used to determine the average price level in the way prescribed by equation 4, which means that a fixed-weight index automatically assigns increasing relative importances to those items whose prices rise most rapidly.

The Homeownership Issue

The homeownership component of the CPI has contributed greatly to the recent gyrations in the CPI's inflation rate. (See table 4.) For example, it added 3 points to the inflation rate in the first half of 1980 and was chiefly responsible for the zero inflation rate recorded for July 1980.

The CPI and the PCE deflator treat homeownership costs very differently. Table 3 shows how much of the difference between the CPI and

PCE rates of inflation was attributable to conceptual differences between the two indexes during 1978–80. For example, during the first half of 1980 differences in coverage led the CPI to show 2½ points more inflation than the PCE deflator. In each period more than all of this difference came from the disparate treatments of homeownership in the two indexes; other differences in coverage actually led the CPI to show less inflation. If the BLS used the BEA concept of imputed rent rather than its own concept of homeownership costs, the CPI would have shown 1.1 points less inflation in 1978, 1.8 points less in 1979, and a whopping 3.5 points less inflation during the first half of 1980.

Should the treatment of homeownership costs in the CPI be revised? And, if so, how? Would alternative approaches lead to a less volatile index than we now have? To answer these questions, I first explain the current methodology of the CPI and discuss ways of improving the homeownership index within the confines of its current conceptual basis. I then turn to entirely different conceptual approaches to the measurement of homeownership costs—approaches that seem to have more economic appeal.

How the CPI Measures Homeownership Costs[5]

The CPI, in roughly its current form, dates back to 1921. But purchases of new houses were not included in the original market basket. In 1940, when the market basket was revised, the index was upgraded and monthly publication began; but new homes were still not included. Only in the major revision of the CPI in 1953 did purchase of a new home come to be considered part of the standard market basket. The treatment of homeownership costs today is very similar to what it was when they first entered the index in 1953. Possible changes were considered, but rejected, as part of the last major CPI revision in 1978, despite staff recommendations to the contrary.

The current treatment of homeownership costs by the BLS can best be understood if it is remembered that the CPI is not a cost-of-living index,

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5. This section is based on Bureau of Labor Statistics, *The Consumer Price Index: Concepts and Content over the Years*, Report 517 (GPO, May 1978); Walter Lane, "The Costs of Homeownership: A Key Component of the Consumer Price Index," *Seller/Servicer* (September–October 1979), pp. 2–5; and personal conversations with Walter Lane at the BLS.

Table 5. Composition of the CPI Homeownership Index in December 1979 and Rate of Change of Its Components, December 1977 to June 1980

Item	*Relative importance in all-items CPI, December 1979*	*Relative importance in homeownership index component, December 1979*	*Annual rate of change, December 1977 to June 1980 (percent)*[a]
Homeownership	0.249	1.000	17.7
Home purchase	0.104	0.417	13.0
Contractual mortgage interest cost	0.087	0.347	32.9
Property taxes	0.017	0.068	−0.4
Property insurance	0.006	0.022	11.1
Maintenance and repairs	0.036	0.145	10.9

Sources: BLS, *CPI Detailed Report, June 1980* (GPO, 1980), tables 1 and 5, pp. 9–14, and similar preceding reports.

a. Not seasonally adjusted; calculations based on unrounded data.

although it is often used as such.[6] Instead, the CPI is an index of current purchase prices, which draws no distinction between durable goods and nondurable goods. The purchase of a new house, and the mortgage that goes along with it, is treated just like the purchase of a television set or a sweet potato, despite the fact that durable goods are consumed (and hence yield utility) only gradually over time.

More specifically, the homeownership component of the CPI consists of five parts, which are listed in table 5 with their relative importances in December 1979 and recent rates of change. Homeownership accounts for a big part of the CPI, about one-quarter of the entire index.[7] In terms of relative importances in the CPI, homeownership costs are almost five times more important than residential rents—a comparison that already suggests overweighting because only about two-thirds of dwelling units are owner-occupied. The three other components of the homeownership index—property taxes, insurance, and maintenance—are of no interest here. They are treated just like any other CPI item, are of minor importance in the overall CPI, and have accounted for none of the recent spectacular behavior of the index.

[6] Official BLS publications are quite clear on this point. See, for example, BLS, *The Consumer Price Index*, pp. 2–3. Ironically, the CPI originated during World War I when the Shipbuilding Labor Adjustment Board needed a cost-of-living measure on which to base a "fair wage scale." The CPI was called a cost-of-living index until World War II, when its failures in this regard became widely recognized.

[7] When the new CPI was introduced in January 1978 the relative importance of homeownership was only 0.228. The point made above about the arithmetic of price indexes is not trivial.

It is the two major components, home purchase and mortgage interest costs, that command our attention. Together they account for nearly 20 percent of the entire CPI, and they have contributed mightily to its recent volatility. How does the BLS divide monthly mortgage payments into two portions—one attributable to the price of a house and the other to the mortgage interest rate?

HOME PURCHASE

The cost of purchasing a new home enters the index just like the cost of any other good, with a weight determined by the 1972–73 expenditure survey and the 1972–74 diary survey. In computing the weight from the survey data, the BLS included the purchase price of homes bought in the survey year minus the selling price of homes sold in that year plus any transactions costs associated with these purchases and sales. In determining the weight of home purchase, resales of existing owner-occupied structures cancel, leaving only newly constructed homes or homes that, for some other reason such as conversions from rental status, enter the owner-occupied category for the first time.[8]

At first glance this seems a reasonable procedure. But on further reflection the investment aspect of any durable good begins to muddy the waters. It seems clear enough that, if my neighbor and I had sold our homes to each other in 1973, the BLS should have ignored both transactions. However, consider the case of John Doe who bought his first house (a resale) in 1973 and lived in it until he died. Should a zero weight be given to Doe's purchase? It seems that it should not. After all, Doe did spend part of his budget on housing.

The reason for the difficulty is easy to pinpoint, but, I think, impossible to resolve within the BLS's conceptual framework. Houses are durable goods. In a very real sense, an individual "spends money" on housing as he lives in the house, not when he first buys it. If the BLS had adopted the economic approach and priced the service flow of this durable good instead of its purchase price, it would have ignored the house swap between my neighbor and me, and counted John Doe's flows of implicit expenditures on housing as he made them (that is, one year's worth would have been recorded in the survey year).

[8] However, the prices of used homes certainly do count in the index (see below).

However, the BLS prices home purchases, not service flows. (I return to this below.) The weighting issue is probably unresolvable, given this conceptual treatment, because deciding whether to include or exclude resales is the same as deciding whether the seller of an existing house *earns income* from the sale or *makes a negative expenditure*. Standard CPI concepts call for ignoring the sale if it is construed as an income source, but including it if it is construed as a negative expenditure. I submit that the distinction between earning positive income and making negative expenditures is extremely subtle.

Once a weight for home purchase is established, the next step is to derive a house price index to which this weight can be applied. The BLS now constructs its house price index from data on sales of houses with Federal Housing Administration financing. There are serious problems with these data. According to the BLS, "FHA-insured housing constitutes a small and unrepresentative segment of the market. In 1973, these FHA-guaranteed purchases represented only about 6 percent of the home purchase market."[9] One reason for this is that the FHA mortgage ceiling, which is now $89,500, effectively eliminates all higher-priced housing from consideration. Another is that some areas (such as the Northeast) have very few FHA transactions. Each of these probably biases the rate of change of house prices, but possibly in opposite directions.[10] The truncation problem caused by the FHA mortgage ceiling is obvious. Even though the ceiling is periodically adjusted upward, preliminary work by the BLS suggests that this may have been a serious source of downward bias in recent years.[11] On the other hand, underrepresentation of the Northeast probably biases the home price index upward. If it is true, as many observers of the housing market suspect—that lower-priced homes have had faster rates of appreciation than higher-priced homes in recent years—then this, too, would impart an upward bias to the rate of change of the CPI home price index.[12]

On balance, while the potential biases are great, it is hard to guess how severe they may be or even in which direction they may go. In addition to the large potential bias, the small sample size in many cells makes sampling

[9] BLS, *The Consumer Price Index*, p. 13.

[10] In addition, processing delays mean that the CPI home-purchase index often lags several months behind the actual data.

[11] John S. Greenlees, "Hedonic Indexes of Home Purchase Prices: Preliminary Report," Bureau of Labor Statistics (forthcoming).

[12] This is stressed, for example, by Greenlees (ibid).

variance in the FHA data quite large and requires frequent imputations. A better source of data on house prices thus seems imperative. The BLS staff is, incidentally, well aware of the problems with the FHA data.

MORTGAGE COSTS

The other major component of the homeownership index—and by far the most troublesome one—is "contracted mortgage interest costs," a component that combines the home purchase prices just explained with an estimated mortgage interest rate.

To develop a representative mortgage interest rate, the BLS collects quotations from the Federal Home Loan Bank Board for mortgages closed during the first five business days of each month, and uses these quotations to construct a mortgage interest rate index for the *following* month.[13] A one-month delay is built into this procedure: the July index records mortgages closed in June, and so on. There is no particular reason, other than historical inertia, for this data-processing lag.

But there is another, longer lag between changes in mortgage rates and their appearance in the CPI that is not so easily avoided. Mortgages closed in June probably correspond to mortgage commitments made mostly in March, April, and May. On average, the closings lag behind commitments by about two months; but the corresponding mortgage rates need not follow this lag mechanically. When rates are rising, April commitments closed in June will typically be at April interest rates. But when rates are falling it is more typical for banks to lower the rate to the current market rate; April commitments closed in June would carry the June interest rate. Thus the CPI mortgage interest rate index, which properly includes closing rates rather than commitments, may fall much more rapidly than it rises.[14] The two lags in combination mean that changes in the CPI mortgage interest rate index lag behind changes in market interest rates by about three months on average.

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[13] The BLS does this for each of 240 cells: 40 geographical areas, 3 down payment classes, and a distinction between mortgages on new and existing homes. These conventional mortgages take 86.5 percent of the weight. The remaining 13.5 percent goes to the FHA and VA ceiling rates.

[14] The July 1980 index provides an outstanding example. The mortgage interest rate index fell at an annual rate of 48 percent from June to July. This was enough to make the homeownership component of the CPI fall at an annual rate of 17 percent and cause the all-items index to be virtually unchanged despite rising prices of many other goods and services.

The procedure the BLS uses to attach a weight to their mortgage cost index seems quite odd. During the survey year, the BLS recorded the interest payments (not including amortization) that would be due over the first half of the lifetime of each new mortgage. These future contractual mortgage payments were simply added, with no discounting. Summing these payments across all units in the survey led to the weight for "contracted mortgage interest cost" in the CPI, which is thus highly dependent on the interest rates that prevailed during the base period.

An example will help clarify the procedure, and also explain why I view it as a serious case of double-counting (or possibly one-and-a-half counting). Consider a new home bought in 1972 for $40,000, a reasonably typical amount. If the down payment was $8,000 (20 percent), and a $32,000 mortgage was taken out at 7½ percent interest, the annual mortgage payment (ignoring within-year compounding) would have been $2,834.72.[15] Because the first half of the lifetime of the mortgage is 12.5 years, this means that the BLS would have included mortgage payments of 12.5 × 2834.72 = $35,434, minus $9,005 in amortization, or $26,429 in interest payments. Thus, when it came to determining the weight for homeownership, $40,000 would have been included in the "home purchase" component and another $26,429 in the "contracted mortgage interest cost" component. This strikes me as a serious case of overweighting, and we can be grateful that, for some reason, the BLS decided to include only half the mortgage payments, not all of them.[16] When a family purchases a home it makes some down payment ($8,000 in the example) and commits itself to make future mortgage interest payments that are equal in discounted present value to the remainder of the purchase price ($32,000 in the example)—*if* the mortgage rate is used to do the discounting. Thus, it seems to me, *if* it is desired to split the total purchase into two components (home price and mortgage cost), a minimal requirement should be that the two pieces together add up to the purchase price of the house ($40,000 in the example). The current treatment does not do anything like this, and as a result it would appear that the weight accorded to homeownership is seriously exaggerated in the index. This is particularly unfortunate because the homeownership component is so volatile. Furthermore, the treatment biases the whole CPI in periods in which homeownership costs as measured in the index are rising at dramatically different rates than other prices.

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[15] The Federal Home Loan Bank Board's series on yields on new conventional mortgages was 7.6 percent in 1972. I use continuous compounding formulas here.

[16] Between 1953 and 1964 *all* the mortgage payments were included.

There is direct evidence that the relative importance of homeownership is exaggerated in the CPI. For example, in 1978 personal consumer expenditures on tenant-occupied nonfarm dwellings in the national income accounts amounted to $54.2 billion, while the corresponding figure for owner-occupied dwellings was $142.9 billion. The ratio of the latter to the former is 2.6. Yet the relative importances of owner-occupied and rental housing in the CPI during 1978 averaged 0.232 and 0.056, respectively. The corresponding ratio is 4.2, more than half again as large. Or consider the five experimental alternatives that the BLS has recently begun to publish as part of its monthly CPI release. In December 1977 the relative importance of the official homeownership index was 0.228, and it ranged from 0.087 to 0.145 for the five experimental alternatives.

Economic Approaches to Measuring Homeownership Costs

Everyone seems to agree that the current treatment of homeownership in the CPI is wrong. But there is less agreement on what should replace it.[17] The goal, however, should be quite clear: an empirical counterpart is needed to the theoretical concept of the service flow of a durable good. This is quite different from the current CPI convention of including durable purchases when they are made.

RENTAL EQUIVALENCE

To an economist, the natural place to begin looking for an empirical measure of service flows is the rental market. Imputed rents on owner-occupied houses, for example, are included as a component of personal consumption expenditures in the national income accounts. The BLS has investigated this option in one of its experimental series—rental equivalence. This index is constructed by applying to the CPI rent index a weight derived from the estimated rental value of all owner-occupied homes in the 1972–73 Consumer Expenditure Survey. As anyone who has studied the CPI in recent years knows, the rent index is one of the CPI's slowest growing components.[18] So it is not surprising that the rental equivalence approach yields a homeownership index that inflates much more slowly than the current official index (compare the homeownership indexes for the first two rows of table 6). Similarly, the overall CPI inflation rate for each year shown in the table would have been lower under the rental equivalence approach, and the 1977–80 acceleration of inflation would have been much less (compare the all-items CPI for the first two rows of the table).

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[17] I argue below that there is good reason for this disagreement.

But before I declare the BLS's problem solved, I should note that the CPI rent index is probably not appropriate for imputing rents to owner-occupied dwellings. The mix of housing types that are rented is very different in many respects (location, size, number of rooms, age, numbers of houses and apartments, and so on) from the mix of housing types that are owner-occupied. There is therefore no reason to believe that the levels of rents on rented dwellings are good proxies for imputed rent levels on owner-occupied dwellings. The story is less clear, however, for growth rates. The factor inputs used to build and maintain rented dwellings are, for the most part, the same as the factor inputs used to build and maintain owner-occupied dwellings. Thus if Tobin's "q" for rented houses and his "q" for owner-occupied houses were both constant at unity, there would be good reason to think that the *growth rate* of a properly weighted index of rents would approximate quite well the *growth rate* of imputed rents on owner-occupied dwellings. However, the two versions of q undoubtedly diverge from unity quite frequently, and need not move together in the short run. Thus rental equivalence is not without its perils.

In brief, although rental equivalence may be the conceptually correct approach, there are potentially serious problems in implementing it empirically by using directly observed rents. These are problems that the BLS should be and is working on. Specifically, answers are needed to the following questions. How good is the CPI rent index as an index of rental rates on rented dwellings? How well does an index of observed rental units serve as a proxy for the behavior of imputed rents on owner-occupied housing; that is, do the q on the two types of dwellings move more or less together? (It is easy to think of reasons why they might not—changes

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[18] In July 1980 the CPI rent index stood at 192.1 (1967 = 100), compared to the all-items CPI of 247.8. Some have argued that the CPI rent index understates the increase in rents because it fails to correct for the fact that its sample of dwellings grows older each year.

Table 6. Alternative Treatments of Homeownership in the CPI, 1977 to June 1980
Percent change from previous year

	December 1977		December 1978		December 1979		June 1980	
Item	*Homeownership indexes*	*All-items CPI*	*Homeownership indexes*	*All-items CPI*	*Homeownership indexes*	*All-items CPI*	*Homeownership indexes*	*All-items CPI*
Current CPI	9.2	6.8	12.4	9.0	19.8	13.3	23.8	14.3
Rental equivalence	6.5	6.3	7.3	7.9	7.9	10.8	9.4	11.1
User cost								
Current interest rate	2.5	5.9	5.7	7.8	28.2	13.2	47.7	15.6
Average interest rate	0.4	5.7	−1.1	7.1	20.5	12.1	36.5	13.7
Outlays								
Current interest rate	10.4	6.6	12.0	8.5	22.6	12.5	30.6	13.4
Average interest rate	9.0	6.5	5.3	7.8	11.2	11.3	13.5	11.5

Source BLS, "The Consumer Price Index—October 1980," tables c and d.

in tax laws are one example.) And how feasible is it for the BLS to find a sample of rented dwellings that matches the characteristics of the universe of owner-occupied dwellings?

I do not pretend to know the answers to these questions. If they turn out favorably, devising a new rent index more representative of owner-occupied dwellings has much to recommend it. If the BLS deems the task impossible, an economist naturally thinks next of user cost.

USER COST OF HOUSING

Measuring homeownership costs by a user-cost concept is another alternative that the BLS has considered. User cost was developed by Dale Jorgenson for a precisely analogous problem: industrial capital is normally purchased, not rented, and hence market rental rates were not available. Jorgenson's user cost of capital was meant to represent the rental rates that capital goods would command if they were rented. On the surface, it is not hard to modify Jorgenson's ideas for the case of housing. But, once again, there are difficulties in implementing it empirically.

To "rent" their homes, homeowners "pay" each month: mortgage interest on the funds they have borrowed, implicit interest (opportunity cost) on the equity in their houses (which they could invest elsewhere), property taxes and insurance, maintenance and repairs. As offsets to these expenditures, homeowners receive (in addition to the service yield of their homes) capital gains (or losses) net of any depreciation that occurs, and savings on their personal income taxes due to the favored treatment of owner-occupied housing in the tax code. In the appendix to this paper the interest, tax, and capital gains components of user cost are shown to be

$$\text{(9)}\quad C(t) = P(t)[(1-u)(r^*(t)+\tau(t)) + \delta - \pi(t)] + (1-u)V\left[\frac{1-e^{-r(T-t)}}{1-e^{-rT}}\right](r - r^*(t)),$$

where

t = time elapsed since the house was purchased

$C(t)$ = user cost in month t

$P(t)$ = price of the house

u = personal income tax rate (assumed to be constant through time)

$r^*(t)$ = opportunity cost of funds in month t

r = mortgage interest rate (assumed to be constant through time)
$\tau(t)$ = property tax rate (percent of true market value)
δ = depreciation rate (assumed to be constant through time)
$\pi(t)$ = accrued capital gains rate in month t
V = original face value of the mortgage
T = duration of the mortgage.

Equation 9 differs from the standard user-cost formulation that is so familiar from the investment literature in two important respects. The first is that the equation includes actual ex post realized capital gains on the house rather than ex ante expected gains. This is appropriate because the objective is to develop a series representative of what it actually cost to own a particular house for the month under consideration, not to ascertain the relative price that should guide investment decisions. The second is the addition of the last term in 9, which merits discussion because it helps illuminate some of the issues.

Suppose initially that observed market rates on home mortgages are used as a proxy for the opportunity cost of funds.[19] For new mortgages ($t = 0$), the last term drops out because $r^*(0) = r$. An issue arises, however, for old mortgages. Suppose also that interest rates have risen since the mortgage was taken out, so that $r^*(t)$ exceeds r and the last term in 9 is negative, implying that user cost is below what the standard formulation suggests. Why? The reason is that the standard user-cost formula charges homeowners the current market interest rate, $r^*(t)$, on both the funds they borrow from themselves (their equity in the houses) and the funds they borrow from the bank (their outstanding mortgage balances). But, in fact, while homeowners do implicitly pay $r^*(t)$ on their own equity, they do not pay $r^*(t)$ to the bank. The bank is locked into collecting r for the life of the mortgage. So when interest rates rise, homeowners receive part of the financing at a cheaper rate than they would in a world in which mortgage rates were renegotiable every period. Conversely, if interest rates fall ($r > r^*(t)$), homeowners will pay more for credit than they would in a spot mortgage market unless they choose to refinance and bring r down to $r^*(t)$. This is the meaning of the last term in 9.

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[19] Robert Gillingham has argued persuasively that it would be better to use the internal rate of return on housing for r^*. However, to calculate this internal rate of return, it is necessary to know the equivalent rent. Hence Gillingham's point is actually an argument to use rental equivalence—*if* one can measure it. See Robert Gillingham, "Estimating the user cost of owner-occupied housing," *Monthly Labor Review*, vol. 103 (February 1980), pp. 31–35.

Other practical issues arise in trying to make 9 operational. For example, what tax rates should be used and how would one measure depreciation? These are issues that the current BLS experimental user-cost series do not handle well. Improvement is needed; but I do not dwell on these issues here because there is a much broader issue to address. Would one expect a user-cost index, properly constructed along the lines of 9, to track the behavior of rental rates? The answer seems clearly to be no; and the reasons are quite instructive.

Because the current market interest rate and the one-period *actual* capital gains rate have such high weights in 9, the resulting user-cost series will be extremely volatile. (Some direct evidence on this is offered below.) Would market rental rates be this volatile if the houses now occupied by their owners were rented instead? I am quite confident that they would not be. Certainly the current market for rented dwellings exhibits no such volatility, and for good reasons. One is that the market for rental housing is not organized as a spot market, probably because the transactions costs of getting in and out are so immense. Even if there were no long-term contracts, it seems most unlikely that monthly rents would dance in tune with monthly fluctuations in interest rates or capital gains. The reason is that the market for rented housing is one in which the rental rate equilibrates the flow supply of housing services with the flow demand. Suppose the stock demand for housing rises. Will rents jump immediately to "clear the market?" It is not likely. Instead, the prices of houses will increase enough (with corresponding effects on the user cost) to equate the stock demand with the (temporarily fixed) stock supply. Tobin's q will therefore be pushed above unity, encouraging the construction of more houses. The disequilibrium will persist until enough new houses have been built to reduce q back to unity. Rents might rise slightly during the adjustment period (a housing shortage), but they would not be expected to rise much.

These "hunches" are backed by direct evidence that the user costs are too volatile to represent market rents. In his paper in this issue, Hendershott calculates a user-cost series for rented dwellings that is conceptually similar to my equation 9. When this series is compared with the actual observed rental rates in that market (see his figure 1), it is clear that the former is far more volatile than the latter.

How much differently would the CPI have behaved in recent years if the BLS had adopted user cost in place of its current treatment of homeownership? The BLS currently has two experimental user-cost series; one uses current mortgage interest rates, the other, a fifteen-year weighted average of mortgage rates. However, the weighting scheme, which reflects the age distribution of existing mortgages, is heavily front-loaded: 31 percent of the weight is on the first 1½ years and 69 percent is on the first 5½ years. So the two series behave more similarly in practice than might be expected. The recent behavior of the two series is summarized under "user cost" in table 6.

In 1977 and 1978, substitution of user cost for current BLS methods would have led to a smaller measured inflation rate, as expected. Under present concepts, the rates of increase of homeownership costs in the two years were 9.2 and 12.4 percent, respectively. Under a user-cost measure, the corresponding rates would instead have been 2.5 and 5.7 percent using current mortgage rates or 0.4 and −1.1 percent using average mortgage rates. These are large differences. Using average mortgage rates would have reduced the overall inflation rates by about 1 percentage point in 1977 and 2 points in 1978, making them even slightly lower than under rental equivalence.

The tables turn in 1979 and 1980, however. The user-cost measures actually increased at a more rapid rate than the official homeownership index, and much faster than the rental equivalence measure. As expected, the user-cost measures seem to be inherently volatile. The volatility problem becomes particularly acute in periods, like the current one, in which the level of the user-cost series is quite low so that relatively small absolute changes in user cost correspond to very large relative changes. This follows from 9. For simplicity, suppose that u, τ, and δ are all constant, and that all mortgages bear the current interest rate, $r(t)$ in each period. Then the user-cost formula becomes

$$C(t) = P(t)[(1 - u)(r(t) + \tau) + \delta - \pi(t)].$$

A straightforward calculation shows that the percentage change in user cost from one period to the next is given by

$$\frac{\Delta C(t)}{C(t)} = \frac{\Delta P(t)}{P(t)} + \left[\frac{(1 - u)r(t)P(t)}{C(t)}\right]\frac{\Delta r(t)}{r(t)} - \left[\frac{\pi(t)P(t)}{C(t)}\right]\frac{\Delta \pi(t)}{\pi(t)}.$$

As $C(t)$ becomes very small, the weights attached to the changes in interest and capital gains rates become quite large. (I wonder what the BLS does when $C(t)$ becomes negative!)

This is not a nitpicking issue. In recent years, user-cost measures for owner-occupied housing have in fact been very low.[20] It might be thought that this problem is finessed because items with low price tags are automatically given small expenditure weights in a price index. But as mentioned above, the CPI is a Laspeyres index with 1972–74 as the base period. Thus the weight attached to $C(t)$ depends on its average level in 1972–74 rather than on its (very low) current level.

This is where I came in. The perceived problem with the current CPI treatment of homeownership is that it is too volatile. Yet a user-cost series is likely to be even more volatile.[21] The basic problem is inherent in using an interest rate as a component of a price index, and it turns out that user-cost measures assign even more importance to interest rates than does the current CPI methodology.

Conclusions: Improving the Measurement of Homeownership Costs

Nearly everyone seems to agree that the CPI provides a seriously distorted picture of changes in homeownership costs. Can it really make sense to state, as the index does, that the cost of homeownership rose at a 25 percent annual rate between December 1979 and June 1980 and then fell at an annual rate of 17 percent between June 1980 and July 1980? Can the picture be brought into sharper focus and the CPI tamed?

There are three basic candidates and none of them is especially appealing. First, marginal improvements could be made in BLS procedures without in any way overhauling the basic conceptual framework that is currently in use. Among these would be to eliminate unnecessary lags in processing the mortgage rate data of the Federal Home Loan Bank Board and the FHA house price data; to use data on home prices from a broader, more representative sample than the FHA data; to replace the current

[20] See, for example, the paper by Patric Hendershott in this issue.

[21] The extreme volatility of the user-cost series is mitigated in part by the lower weight (only about 0.10 to 0.11) accorded homeownership when the experimental user-cost formulations are employed. In 1979, for example, overall CPI inflation would have been about the same as in the official index if user cost with current mortgage rates had been used, and 1.2 points lower under user cost with average mortgage rates (see table 6).

mortgage interest rate with a long-term weighted average; and to reduce the weight on homeownership, which seems excessive on several grounds. These changes would not move the CPI's treatment of homeownership costs any closer to the treatment suggested by economic analysis, but they would at least reduce what now appears to be excessive volatility in homeownership costs. This is a prescription for powdering a nose when plastic surgery is probably needed.

Second, an effort could be made to develop a sample of rented dwellings that matches as closely as possible the universe of owner-occupied dwellings. As noted above, the job probably cannot be done perfectly. But the remaining shortcomings in the sample might be overcome by appropriate reweighting. It is quite possible that this technique, while far from the perfect solution, will be as close to a "true" measure of rental equivalence as we are likely to achieve, and this approach needs to be explored.

A third candidate is user cost. If measured correctly, user cost can indeed tell us how much it cost typical homeowners to use their homes in a given month. But that hardly makes it the ideal solution. I have argued at some length that a user-cost series is bound to be far more volatile than the rents that would emerge if the owner-occupied housing market were somehow transformed into a rental market.

But what does this mean? Market rents probably would be much less volatile than user cost. Yet user cost is the truer measure of the literal *cost of living* in one's house if it is owned rather than rented. The problem is that homeowners have a split personality—they are both consumers of housing services and investors in houses as assets. The two roles are inextricably bound together for owner-occupied houses, virtually by definition. So it is not surprising that people have difficulty deciding which measure of homeownership costs is "correct."

Consider the example in which Dr. Jekyll rents a house from Mr. Hyde. The cost of owning the house for a month is $C(t)$; implicitly, this is what Mr. Hyde pays. But it is not what he charges Dr. Jekyll. Dr. Jekyll's rent stream, call it $R(t)$, will over a long period of time be equal in present value to Mr. Hyde's user-cost stream. But $R(t)$ will reflect few if any of the monthly "blips" in $C(t)$. Mr. Hyde, the entrepreneur, bears all the risk while Dr. Jekyll pays a steady monthly rent. There seem, then, to be two choices with claims to being correct. On the one hand, perhaps Mr. Hyde should be ignored; he is, in any case, an investor rather than a consumer. Then $R(t)$, rental equivalence, should enter Dr. Jekyll's cost-of-living index. On the other hand, Jekyll and Hyde do inhabit the same body (if at different times!) and thus perhaps they should be amalgamated and a cost of living should be computed for the pair. In this case one is led to user cost, $C(t)$.

It is now the time to choose. I think the current treatment can be eliminated from serious contention. One need only think about the purposes for which the CPI is used to conclude that what is needed is a cost-of-living index based on a service-flow concept of housing, not a current acquisition price index that treats durable purchases as instantaneous consumption. Apart from the use of the CPI by economists (a small and unrepresentative group), it is used mostly for indexing various types of contracts to the price level—wages, social security benefits, and so on. For this purpose, it is clear that what is needed is a cost-of-living index relevant to the group involved (workers, old people, and so forth) rather than an abstract "current price" index. Similarly, economists and others who use the CPI as a source of data for scientific work most naturally define inflation as the rate of change of the so-called true cost-of-living index—the increase in the money cost of buying a given utility level. So in this case scholarly and practical interests seem to coincide. Indeed, I find it hard to imagine whose purposes are better served by a current price index than by a cost-of-living index.

If I were forced to choose between the other two candidates, I would cast my vote for rental equivalence—not because of its conceptual superiority (the consumption and investment aspects of owner-occupied housing really are intertwined), but simply because the numbers so produced will be less volatile. The extreme gyrations in user cost represent only trivial losses or gains of utility when considered in a life-cycle context (and how else can one consider the purchase of a house?). Yet many workers have wages that are tied to the CPI, and even more people have transfer payments that are tied to it. No useful purpose is served by making these escalators so volatile.[22]

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[22] Timing and volatility, not long-run bias, are the issues for public policy. It is not true in any quantitatively important sense that workers with wage escalators or recipients of transfers will either gain or lose in the long run if rental equivalence replaces the current CPI treatment of homeownership. As evidence for this, note that from January 1961 (when it began) through the end of 1977 the compound annual growth rate of the CPI exclusive of mortgage interest costs was 4.36 percent. The compound rate of increase of the all-items CPI was merely 4.44 percent, even though mortgage rates were rising almost steadily throughout this period.

From the macro perspective, the volatility of the CPI often distracts attention from the economy's underlying or "baseline" rate of inflation. I speculate that extreme swings in the CPI inflation rate occasionally contribute to extreme swings in national economic policy. The credit controls and budget-cutting exercises of early 1980, for example, were apparent responses to the bogus 18 percent inflation rates then being reported by the CPI. This is one inflationary distortion we could all live better without.

APPENDIX

Derivation of the User-Cost Formula

IN ADDITION to the notation adopted in the text, it is necessary to define m as the monthly mortgage payment (independent of time) and $B(t)$ as the unpaid mortgage balance at time t. Tax provisions require that m be divided into two components: interest and amortization. If the mortgage yield is r, the monthly mortgage payment will be the value of m that satisfies[23]

$$\int_0^T me^{-rt}\,dt = V.$$

Thus m is given by

$$m = \frac{rV}{1 - e^{-rT}}.$$

The interest component is $rB(t)$. It is clear that $B(0) = V$, $B(T) = 0$, and that in the interim $B(t)$ evolves according to

$$\frac{dB(t)}{dt} = rB(t) - m,$$

which has the solution

$$B(t) = V\left(\frac{1 - e^{-r(T-t)}}{1 - e^{-rT}}\right). \tag{10}$$

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[23] For analytical convenience, continuous-time approximations are used in what follows and insurance and maintenance costs are ignored. My formulas are valid for conventional level-payment mortgages, not for any of the newer forms of mortgage instruments.

The net after-tax interest cost is $r(1-u)B(t)$. To this must be added the opportunity cost of the equity the homeowner provides,

$$r^*(t)(1-u)[P(t)-B(t)],$$

to arrive at total (implicit plus explicit) financing costs.[24]

There are two further items to add. First, because property taxes are deductible in calculating personal income taxes, the net cost of these levies to the homeowner is $\tau(1-u)P(t)$. Second, there is price appreciation to be reckoned with. If, between period $t-1$ and period t, the price per unit of housing increases at a proportional rate $\pi(t)$ but the house depreciates (in terms of physical units) at a proportional rate δ, then capital gains net of depreciation are $(\pi(t)-\delta)P(t)$. Capital gains are assumed to be untaxed.

Putting all these items together, the user cost at time t for a mortgage closed at time zero is

$$\begin{aligned} C(t) &= r(1-u)B(t) + r^*(t)(1-u)[P(t)-B(t)] \\ &\quad + \tau(1-u)P(t) - [\pi(t)-\delta]P(t) \\ &= P(t)[(1-u)(r^*(t)+\tau)+\delta-\pi(t)] + (1-u)(r-r^*(t))B(t). \end{aligned}$$

Substituting equation 10 for $B(t)$ gives equation 9 in the text.

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[24] Note that the equity in the house at time t is $P(t)-B(t)$.

COMPONENTS OF THE CONSUMER PRICE INDEX

Food and Beverages

- Food:
- Food at home:
  - Cereals and bakery products
    - Cereals and bakery products (12/77 = 100)
      - Flour and prepared flour mixes (12/77 = 100)
      - Cereal (12/77 = 100)
      - Rice, pasta, and cornmeal (12/77 = 100)
    - Bakery products (12/77 = 100)
      - White bread
      - Other breads (12/77 = 100)
      - Fresh biscuits, rolls, and muffins (12/77 = 100)
      - Fresh cakes and cupcakes (12/77 = 100)
      - Cookies (12/77 = 100)
      - Crackers and bread and cracker products (12/77 = 100)
      - Fresh sweetrolls, coffeecake and donuts (12/77 = 100)
      - Frozen and refrigerated bakery products and fresh pies, tarts, and turnovers (12/77=100)
  - Meats, poultry, fish, and eggs
    - Meats, poultry, and fish
      - Meats
        - Beef and veal
          - Ground beef other than canned
          - Chuck roast
          - Round roast
          - Round steak
          - Sirloin steak
          - Other beef and veal (12/77 = 100)
        - Pork
          - Bacon
          - Pork chops
          - Ham other than canned (12/77 = 100)
          - Sausage
          - Canned ham
          - Other pork (12/77 = 100)
        - Other meats
          - Frankfurters
          - Bologna, liverwurst, and salami (12/77 = 100)
          - Other lunchmeats (12/77 = 100)
          - Lamb and organ meats (12/77 = 100)
      - Poultry
        - Fresh whole chicken
        - Fresh and frozen chicken parts (12/77 = 100)
        - Other poultry (12/77 = 100)
      - Fish and seafood
        - Canned fish and seafood (12/77 = 100)
        - Fresh and frozen fish and seafood (12/77 = 100)
      - Eggs
      - Dairy Products
        - Fresh milk and cream (12/77 = 100)
          - Fresh whole milk
          - Other fresh milk and cream (12/77 = 100)
        - Processed dairy products (12/77 = 100)
          - Butter
          - Cheese (12/77 = 100)
          - Ice cream and related products (12/77 = 100)
          - Other dairy products (12/77 = 100)
  - Fruits and vegetables
    - Fresh fruits and vegetables
      - Fresh fruits
        - Apples
        - Bananas
        - Oranges
        - Other fresh fruits (12/77 = 100)

- Fresh vegetables
- Potatoes
  - Lettuce
  - Tomatoes
  - Other fresh vegetables (12/77 = 100)
- Processed fruits and vegetables
  - Processed fruits (12/77 = 100)
    - Frozen fruit and fruit juices (12/77 = 100)
    - Fruit juices and other than frozen (12/77 = 100)
    - Canned and dried fruits (12/77 = 100)
  - Processed vegetables (12/77 = 100)
    - Frozen vegetables (12/77 = 100)
- Cut corn and canned beans except lima (12/77 = 100)
- Other canned and dried vegetables (12/77 = 100)
- Other foods at home
- Sugar and sweets
  - Candy and chewing gum (12/77 = 100)
    - Sugar and artificial sweeteners (12/77 = 100)
    - Other sweets (12/77 = 100)
  - Fats and oils (12/77=100)
    - Margarine
    - Nondairy substitutes and peanut butter (12/77=100)
    - Other fats, oils, and salad dressings (12/77=100)
  - Nonalcoholic beverages
    - Cola drinks, excluding diet cola
    - Carbonated drinks, including diet cola (12/77=100)
    - Roasted coffee
    - Freeze dried and instant coffee
    - Other noncarbonated drinks (12/77=100)
  - Other prepared foods.
    - Canned and packaged soup (12/77=100)
    - Frozen prepared foods (12/77=100)
    - Snacks (12/77=100)
    - Seasonings, olives, pickles, and relish (12/77=100)
    - Other condiments (12/77=100)
    - Miscellaneous prepared foods (12/77=100)
    - Other canned and packaged prepared foods (12/77=100)

- Food away from home
  - Lunch (12/77=100)
  - Dinner (12/77=100)
  - Other meals and snacks (12/77=100)
- Alcoholic beverages
- Alcoholic beverages at home (12/77=100)
  - Beer and ale
  - Whiskey
  - Wine
  - Other alcoholic beverages (12/77=100)
- Alcoholic beverages away from home (12/77=100)

Housing

- Shelter
- Rent, residential
- Other rental costs:
  - Lodging while out of town
  - Tenants' insurance (12/77=100)
- Homeownership:
  - Home purchase
  - Financing, taxes, and insurance
    - Property insurance (12/77=100)
    - Property taxes
    - Contracted mortgage interest (12/77=100) cost
      - Mortgage interest rates
  - Maintenance and repairs
    - Maintenance and repair services
    - Maintenance and repair commodities
      - Paint and wallpaper, supplies, tools, and equipment (12/77=100)

- Lumber, awnings, glass, and masonry (12/77=100)
- Plumbing, electrical, heating, and cooling supplies (12/77=100)
- Miscellaneous supplies and equipment (12/77=100)

- Fuel and other utilities
- Fuels:
    - Fuel oil, coal, and bottled gas
        - Fuel oil
        - Other fuels (6/78=100)
    - Gas (piped) and electricity
        - Electricity
        - Utility (piped) gas
- Other utilities and public services:
    - Telephone services
        - Local charges (12/77=100)
        - Interstate toll calls (12/77=100)
        - Intrastate toll calls (12/77=100)
    - Water and sewage maintenance
- Household furnishings and operations
- Housefurnishings:
    - Textile housefurnishings
        - Household linens (12/77=100)
        - Curtains, drapes, slipcovers, and sewing materials (12/77=100)
    - Furniture and bedding
        - Bedroom furniture (12/77=100)
        - Sofas (12/77=100)
        - Living room chairs and tables (12/77=100)
        - Other furniture (12/77=100)
    - Appliances including TV and sound equipment
        - Television and sound equipment (12/77=100)
            - Television
            - Sound equipment (12/77=100)
        - Household appliances
            - Refrigerators and home freezer
            - Laundry equipment (12/77=100)
            - Other household appliances (12/77=100)
                - Stoves, dishwashers, vacuums, and sewing machines (12/77=100)
                - Office machines, small electric appliances, and air conditioners (12/77=100)
    - Other household equipment (12/77=100)
        - Floor and window coverings, infants laundry, cleaning and outdoor equipment (12/77= ∓100)
        - Clocks, lamps, and decor racks (12/77=100)
        - Tableware, serving pieces, and nonelectric kitchenware (12/77=100)
        - Lawn equipment, power tools, and other hardware (12/77=100)
- Housekeeping supplies:
    - Soaps and detergents
    - Other laundry and cleaning products (12/77=100)
    - Cleaning and toilet tissue, paper towels and napkins (12/77=100)
    - Stationery, stationery supplies, and gift wrap (12/77=100)
    - Miscellaneous household products (12/77=100)
    - Lawn and garden supplies (12/77=100)
- Housekeeping services:
    - Postage
    - Moving, storage, freight, household laundry, and drycleaning services (12/77=100)
    - Appliance and furniture repair (12/77=100)

Apparel and Upkeep

- Apparel commodities:
    - Apparel commodities less footwear
    - Men's and boys'
        - Men's (12/77=100)
            - Suits, sport coats, and jackets (12/77=100)
            - Coats and jackets (12/77=100)
            - Furnishings and special clothing (12/77=100)
            - Shirts (12/77=100)

    - Dungarees, jeans, and trousers (12/77=100)
  - Boys' (12/77=100)
    - Coats, jackets, sweaters, and shirts (12/77=100)
    - Furnishings (12/77=100)
    - Suits, trousers, sport coats, and jackets (12/77=100)
- Women's and girls'
  - Women's (12/77=100)
    - Coats and jackets
    - Dresses
    - Separates and sportswear (12/77=100)
    - Underwear, nightwear, and hosery (12/77=100)
    - Suits (12/77=100)
  - Girls (12/77=100)
    - Coats, jackets, dresses, and suits (12/77=100)
    - Separates and sportwear (12/77=100)
    - Underwear, nightwear, hosery, and accessories (12/77=100)
  - Infants' and toddlers'
  - Other apparel commodities
    - Sewing materials and notions (12/77=100)
    - Jewelry and luggage (12/77=100)
- Footwear
  - Men's (12/77=100)
  - Boys' and girls' (12/77=100)
  - Womens' (12/77=100)
- Apparel services
- Laundry and drycleaning other than coin operated (12/77=100)
- Other apparel services (12/77=100)

Transportation

- Private
- New cars
- Used cars
- Gasoline
- Automobile maintenance and repair:
  - Body work (12/77=100)
  - Automobile drive train, brake, and miscellaneous mechanical repair (12/77=100)
  - Maintenance and servicing (12/77=100)
  - Power plant repair (12/77=100)
- Other private transportation:
  - Other private transportation commodities
    - Motor oil, coolant and other products (12/77=100)
    - Automobile parts and equipment (12/77=100)
      - Tires
      - Other parts and equipment (12/77=100)
  - Other private transportation services
    - Automobile insurance
    - Automobile finance charges (12/77=100)
    - Automobile rental, registration, and other fees (12/77=100)
      - State registration
      - Drivers license (12/77=100)
      - Vehicle inspection (12/77=100)
      - Other vehicle related fees (12/77=100)
- Public
- Airline fare
- Intercity bus fare
- Intracity mass transit
- Taxi fare
- Intercity train fare

Medical Care

- Medical care commodities
- Prescription drugs:
  - Anti-infective drugs (12/77=100)
  - Tranquilizers and sedatives (12/77=100)
  - Circulatories and diuretics (12/77=100)

  - Hormones, diabetic drugs, biologicals, and prescription and supplies (12/77=100)
  - Pain and symptom control drugs (12/77=100)
  - Supplements, cough and cold preparations, and respiratory agents (12/77=100)
- Nonprescription drugs and medical supplies (12/77=100):
  - Eyeglasses (12/77=100)
  - Internal and respiratory over-the-counter drugs
  - Nonprescription medical equipment and supplies (12/77=100)
- Medical care services
- Professional services:
  - Physicians' services
  - Dental services
  - Other professional services (12/77=100)
- Other medical care services:
  - Hospital and other medical services (12/77=100)
    - Hospital room
    - Other hospital and medical care services

Entertainment

- Entertainment commodities
- Reading materials (12/77 = 100):
  - Newspapers
  - Magazines, periodicals, and books (12/77 = 100)
- Sporting goods and equipment (12/77 = 100)
  - Sport vehicles (12/77 = 100)
  - Indoor and warm weather sport equipment (12/77 = 100)
  - Bicycles
  - Other sporting goods and equipment (12/77 = 100)
- Toys, hobbies and other entertainment (12/77 = 100)
  - Toys, hobbies and music equipment (12/77 = 100)
  - Photographic supplies and equipment (12/77 = 100)
  - Pet supplies and expense (12/77 = 100)
- Entertainment services
- Fees for participant sports (12/77 = 100)
- Admissions (12/77 = 100)
- Other entertainment services (12/77 = 100)

Other Goods and Services

- Tobacco products
- Cigarettes
- Other tobacco products and smoking accessories (12/77 = 100)
- Personal care
- Toilet goods and personal care appliances:
  - Products for the hair, hairpieces and wigs (12/77 = 100)
  - Dental and shaving products (12/77 = 100)
  - Cosmetics, bath and nail preparations, manicure and eye makeup implements (12/77 = 100)
  - Other toilet goods and small personal care appliances (12/77 = 100)
- Personal care services:
  - Beauty parlor services for women
  - Haircuts and other barber shop services for men (12/77 = 100)
- Personal and educational expenses
- School books and supplies
- Personal and educational services:
  - Tuition and other school fees
    - College tuition (12/77 = 100)
    - Elementary and high school tuition (12/77 = 100)
  - Personal expenses (12/77 = 100)
- Special Indexes:
  - Gasoline, motor oil, coolant and other products
  - Insurance and finance
  - Utilities and public transportation
  - Housekeeping and home maintenance services